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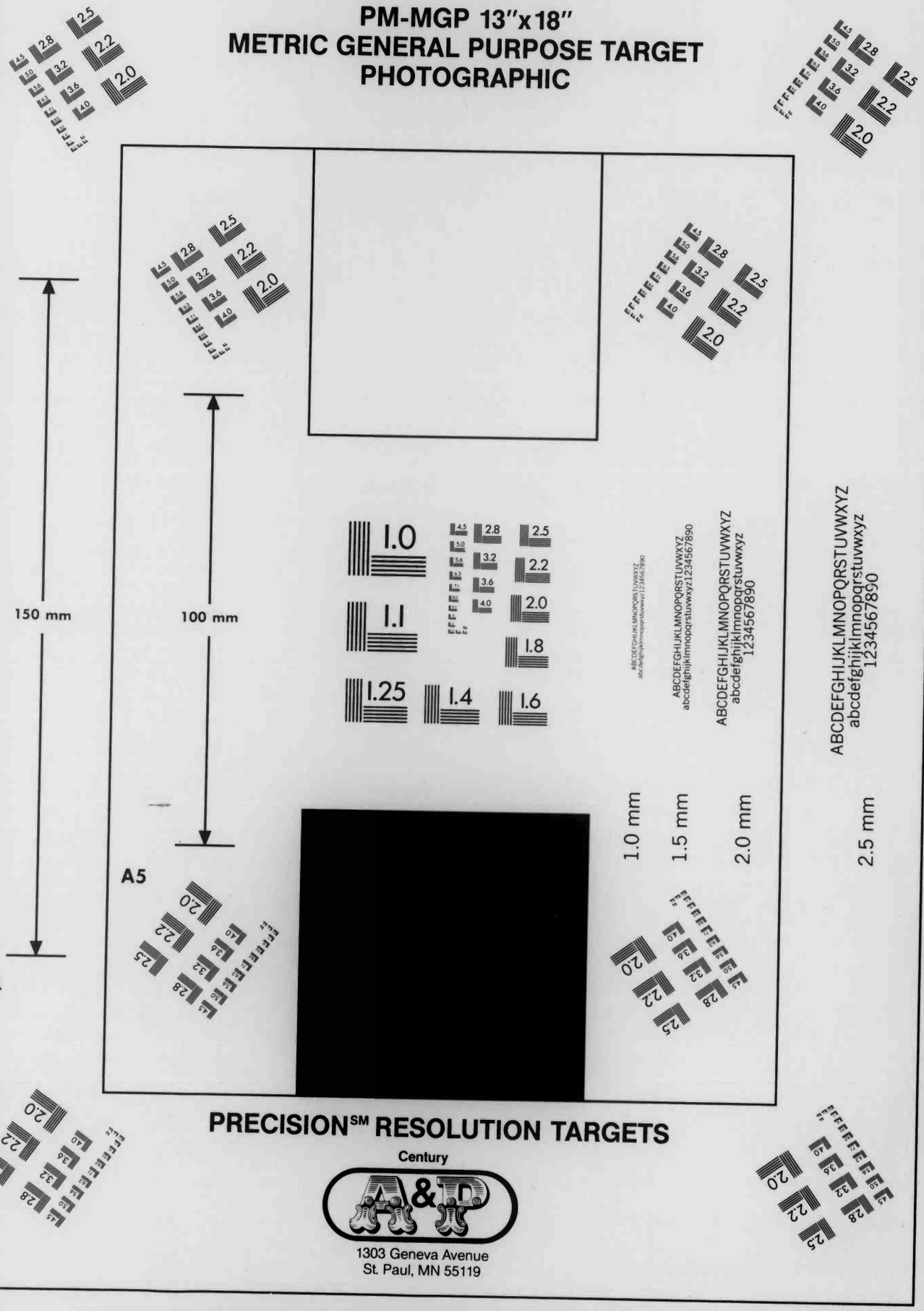

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Bulletin on

SECTION 722

Excess Profits Tax Relief

U. S. TREASURY DEPARTMENT
BUREAU OF INTERNAL REVENUE
BULLETIN
ON SECTION 722 OF THE
INTERNAL REVENUE CODE

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FOREWORD

This Bulletin is issued primarily for employees of the Bureau of Internal Revenue engaged in the administration of the provisions of section 722 of the Internal Revenue Code. It contains information from which taxpayers and their counsel may obtain the best indication of the current trend of official opinion in the administration of that section. Although it does not have the force or effect of a published ruling or of a Treasury decision, its provisions will guide the administrative officers engaged in the consideration of excess profits tax cases.

(Signed) JOSEPH D. NUNAN, JR.
Commissioner of Internal Revenue

November 2, 1944

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Part I

INTRODUCTION

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(A) History and background of general relief under section 722.

The excess profits tax law, as enacted by the Second Revenue Act of 1940, provided certain methods of adjusting base period income and income during the excess profits tax taxable years for the purpose of relieving taxpayers from excess profits tax on normal income. These provisions were supplemented by the Excess Profits Tax Amendments of 1941 and the Revenue Act of 1942. Included in these so-called special relief measures are provisions to cover such usual situations as growing corporations, abnormal base period deductions, fluctuations in income among excess profits tax taxable years and abnormal income in excess profits tax taxable years.

The Second Revenue Act of 1940 also contained a general relief provision, section 722 of the Internal Revenue Code, to cover the unusual situations not provided for in the special relief provisions. It was only a stop-gap provision, written in the most general terms, pending study by staffs of the Treasury and the Joint Committee on Internal Revenue Taxation and consultation with taxpayers and tax practitioners with a view towards formulating a more practical version of general relief.

Accordingly, the Excess Profits Tax Amendments of 1941 specifically provided for general relief in two types of situations. One type covered the occurrence of some unusual or abnormal event during the base period which substantially depressed the base period income. The situations of this type under which taxpayers would be entitled to general relief were, however, restricted by the provision that "high prices of material, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for that product, or for the output of the taxpayer, shall not be considered abnormal." The other type of situation covered was one in which the character of the business on January 1, 1940, was different from the character of the business during the base period.

The increase in the excess profits tax rate to 90 percent in 1942 emphasized the inequity of treating any part of normal profits as excess profits. In this respect, the committee reports on the Revenue Act of 1942 contained the following statements (H. Report No. 2333, Seventy-seventh Congress, First Session—[C. B. 1942-2, 390]):

"Need for the Legislation

"The need for this legislation was recognized when the excess-profits tax was enacted in 1940, and in the excess-profits tax amendments of 1941, as pointed out in the committee reports on those Acts. (H. Rept. No. 146, S. Rept. No. 75, on H. R. 3531, Seventy-seventh Congress, first session [C. B. 1941-1, 550-565].)

"It was there stated that equitable considerations demand that every reasonable precaution should be taken to prevent unfair application of the excess-profits tax in abnormal cases; that high rates on excess profits are thoroughly justifiable if the income subject to tax is clearly of the type intended to be reached. The rates now proposed increase the need for expanding the application of the relief section to cases that do not fall under the specific provisions in order to remove inequities and alleviate certain hardships. The amending provisions expanding the operation of the present section 722 are based on experience gained since its enactment and on previous experience with excess profits taxes in the United States and abroad. Such experience demonstrates that abnormal and unusual cases arise, diverse in character and unforeseeable, for which special legislation is necessary if the purpose of the law is to be carried out."

Accordingly, the present version of section 722 was enacted in the Revenue Act of 1942 and was made retroactively effective for all excess profits tax taxable years. The scope of the then existing general relief provisions was expanded and new provisions were added to cover (1) cases in which base period inadequacies had been caused by strictly economic factors and (2) cases of corporations which came into existence during the excess profits tax taxable years.

(B) General theory and purpose.

The excess profits tax law provides that a corporation must use as a credit in determining excess profits either a stated percentage of its invested capital or a stated percentage of its earnings during a "normal" period, increased or decreased to give effect to capital additions or reductions, whichever produces the lesser tax. The principle has thus been recognized that excess profits represent earnings over and above the normal earnings of a corporation, but not below a certain stated return on invested capital. Corporations which normally earn more than the stated return upon invested capital will therefore use the earnings method. However, the fact that a designated normal period was established for which normal income is to be computed introduces certain possible inequities into the determination of normal earnings. This period may have been one of unusual events in the case of the taxpayer; it may have been one which, although normal for business in general, was not correspondingly normal for the taxpayer because of certain irregularities in the taxpayer's earning experience or because of the fact that its earning pattern was different from that of business in general; and it may have been the period during which the taxpayer commenced business or changed the character of its business and thus represented a period of development for the taxpayer. Likewise, a taxpayer which would customarily earn considerably more than the stated return upon its invested capital, because its operations do not depend primarily upon capital investment, may have come into existence after the base period and accordingly the excess profits credit based on invested capital would not afford the taxpayer an adequate standard for the measurement of excess profits.

Section 722 represents the major relief provision which was designed to make the excess profits credit a fair and workable measure to be used in the computation of excess profits. It was not enacted to afford relief to every corporation paying an excess profits tax. The statutory language, the committee reports, and the regulations indicate that it was enacted to adjust for the effect of *certain* circumstances on the taxpayer's base period income and for the presence of *certain* factors in the taxpayer's business.

Most corporations experience a variety of events and circumstances which affect their businesses, and they continually make changes in the nature of their operations, products, and capacity. These circumstances and changes

may be of a permanent or of a temporary nature; they may increase or decrease income; they may result in a temporary windfall or loss, or in a permanently increased or reduced earning level. Some of these circumstances and changes are routine in the sense that they are constantly encountered by any business under dynamic economic conditions. Others are definitely unusual in the sense that their occurrence would not be anticipated in the normal experiences of the business as constituted. The function of section 722 is not to provide an adjustment to base period net income in every instance in which income would have been higher if the particular event or circumstance had not occurred, or if other events or circumstances had obtained throughout the entire base period. The purpose of section 722 is not to relieve corporations from the effects of adverse circumstances or unwise decisions which enter into and are accepted as an integral part of the operation of doing business, nor to substitute a hindsight judgment of what constitutes normal earnings and normal operations for actual business experience in such cases. Section 722 is a provision to correct an excess profits credit which, because of certain designated events and circumstances is unrepresentative of the normal earnings experience of the taxpayer.

(C) Application and administration.

References were made in committee reports to the desirability of "sympathetic administration" in cases and problems arising under section 722. Sympathetic administration means a fair, reasonable, and intelligent administration, designed to afford to those taxpayers which establish their right to relief the full measure of relief available under section 722. It requires that the action taken with respect to applications for relief be grounded upon the exercise of a sound and informed judgment and an understanding not only of the taxpayer's business but also of the taxpayer's place in its industry and business generally.

The basic problem to be met under section 722 is the determination of whether an excess profits credit is inadequate, whether the factors causing the inadequacy are the type in respect of which the section is designed to afford relief, and what constitutes the normal operations of the taxpayer upon which normal earnings can be computed. That problem is new and difficult and imposes upon examining officers broader procedures than the accustomed one of verification of facts submitted and application of law. It cannot properly be resolved unless and until a thorough study has been made of the entire background of the case to develop the conditions under which the taxpayer operates, as well as the relevant conditions of its industry and of business generally, so that the "whole story" may be obtained.

The proper consideration of claims requires a thorough understanding of section 722 as a whole. The various provisions of the section are interrelated and piecemeal knowledge acquired by a study of a particular subsection in a particular case will not suffice. Since section 722 is an integrated part of the excess profits tax law there must be a thorough knowledge of the operation of that law.

(D) General principles.

Section 722 grants relief to a corporation which can establish first, that because of certain statutory reasons there is an inadequacy in its excess profits credit computed without regard to section 722 which results in an excessive and discriminatory tax, and second, what would be a fair and just amount representing normal earnings to be used as a constructive average base period net

income for the purpose of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period. In determining whether the tax is excessive and discriminatory in the case of a corporation which is entitled to use the excess profits credit based on income, the provisions of section 722(b) are exclusive. In determining whether the tax is excessive and discriminatory in the case of a corporation which is not entitled to use the excess profits credit based on income, the provisions of section 722(c) are exclusive. The mere fact that the taxpayer does not use the excess profits credit based on income on its return for a taxable year for which relief is claimed, because its use would produce a larger tax than the excess profits credit based on invested capital, does not mean that such taxpayer is not entitled to use the excess profits credit based on income.

Even though a corporation is not entitled to use the excess profits credit based on income for some excess profits tax taxable years, it may in later excess profits tax taxable years become entitled to use such credit. In such event, the taxpayer's right to relief for any particular taxable year must be predicated upon the facts as they exist with respect to such year. For example, assume that a taxpayer which first came into existence on July 1, 1940, and thus would not have been entitled to use the excess profits credit based on income, became an acquiring corporation on December 31, 1941 of a component corporation entitled to use the excess profits credit based on income. For taxable years beginning in 1940 and 1941, the taxpayer would have to establish that its excess profits tax was excessive and discriminatory under section 722(c). For the taxable year beginning in 1942, it would have to establish the excessive and discriminatory nature of its tax under section 722(b), regardless of whether relief had been finally determined for the prior taxable years under section 722(c).

In order to be entitled to relief under section 722, the taxpayer must comply with three basic requirements. If it is entitled to use the excess profits credit based on income it must establish that:

1. One or more of the factors set forth in section 722(b)(1), (2), (3), (4), or (5) has occurred, and
2. Because of such factors, its average base period net income is an inadequate standard of normal earnings, and
3. The fair and just amount representing normal earnings, determined in accordance with the principles of section 722, to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period.

If it is not entitled to use the excess profits credit based on income, it must establish that:

1. One or more of the situations described in section 722(c)(1), (2), or (3) is present in its case, and
2. Because of such situation, its excess profits credit based on invested capital is an inadequate standard for determining excess profits, and
3. The fair and just amount representing normal earnings, determined in accordance with the principles of section 722, to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period.

The mere presence of a factor under section 722(b), or the existence of the situation under section 722(c), is not a sufficient qualification for relief. Relief is based upon an inadequacy of the actual average base period net income or the excess profits credit based on invested capital shown to exist as a result of such factor or situation. This inadequacy will obtain if the actual average base period net income is less than the constructive average base period net income determined under section 722, or if (in the section 722(c) cases) the excess profits credit based on invested capital is less than the excess profits credit based upon the constructive average base period net income. Section 722 is an integrated and unified provision which cannot be broken up into two parts, one of which makes a taxpayer eligible for relief (sections 722(b) and 722(c)), and another of which provides for the determination of the amount of relief (section 722(a)). There can be no valid contention that a taxpayer is eligible for relief under one portion of section 722 but is denied a constructive average base period net income under another portion of the section.

The inadequacy of the actual average base period net income or the credit based on invested capital *because* of the factors mentioned in section 722(b) or section 722(c) is the reason why the excess profits tax is excessive and discriminatory, and why relief is granted. This inadequacy test is not only mandatory under the statute, but also is the connecting link between the physical or economic factor producing an average base period net income or an excess profits credit which is not a proper yardstick in determining excess profits and the ultimate relief under section 722(a) which provides such a standard. If this connecting link is not present, there can be no relief, despite the presence of the factor or despite the claimed inadequacy of either the average base period net income or the excess profits credit based on invested capital.

Accordingly, the mere existence of an event or circumstance under section 722(b) does not automatically mean that the average base period net income is an inadequate measure of normal earnings. Unusually high earnings may have been realized by the taxpayer during one or more years of the base period, or the statutory growth formula (section 713(f)) may offset the effect of reduced earnings during the first half of the base period. So also, the mere fact of low earnings during the base period is not itself an indication of an inadequacy, since those earnings might be caused by factors entirely normal and usual in the taxpayer's case, from which section 722 gives no relief (with the exception of situations covered by section 722(b)(3)).

(E) Concept of normal earnings.

The concept of normal earnings must necessarily be defined in terms of periods of time and normal business operating conditions. Business conditions change from year to year. What would be normal conditions for one year will not necessarily be normal conditions for another year. The excess profits credit based on income is based on a four-year average of earnings. This average is necessary to level off good or poor business conditions present in any particular year. It indicates that no one set of business conditions existing in any one base period year is considered proper in determining normal earnings, but that an average of conditions such as obtained in the base period should be considered for that purpose.

Normal operating conditions contemplate conditions existing after the business has reached a degree of maturity. Thus, a business might experience a loss in its first year which was attributable to its initial development and which would not recur once that development had ended. Such a loss could

not be said to be normal and the conditions producing it could not be said to represent normal operating conditions for the business.

It is important to note that normal operating conditions of a taxpayer must be established with respect to that taxpayer on the basis of its position in the industry of which it is a member, and may not be assumed to be an average of the conditions in the industry, or the conditions experienced by the most or least successful businesses in that industry. Under section 722 normal earnings must be established with respect to the particular taxpayer which seeks relief, and normal operating conditions, upon the basis of which such earnings will be determined, must likewise be so ascertained.

One other aspect of normal operating conditions should be considered. In the last sentence of section 722(a) Congress stated that any event or condition affecting the taxpayer, the industry of which it is a member, or taxpayers generally, occurring or existing after December 31, 1939, shall not be taken into account in determining the constructive average base period net income. Thus, economic conditions after that date are, as a matter of law, not to be considered in determining normal operating conditions or normal average earnings. This categorical statutory prohibition does not, however, forbid the elimination of unusual or abnormal economic circumstances existing before December 31, 1939. The relief allowable under section 722 is limited to a "fair and just amount representing normal earnings." Thus, the mandate of the statute is a clear indication that earnings based upon abnormal events are not to be considered. Consequently, if adjustments are made in the earnings for particular base period years affected by abnormally poor circumstances, adjustments must also be made for years affected by abnormally good circumstances to insure a constructive average base period net income which can fairly represent normal earnings.

Whether events or circumstances are to be considered abnormal must be left for determination in each particular case. In making this determination, the frequency and regularity of the event or circumstance and its relation to the nature and extent of the taxpayer's operations must be considered. No conditions induced by the war can be considered to be normal whether such conditions were manifested before or after December 31, 1939.

Abnormally high income, however, does not result only from activities related to the war. It can result from any circumstances which would be considered unusual and peculiar in the experience of the taxpayer. These abnormally favorable circumstances may occur as the result of conditions peculiar to the taxpayer's business, as for example, the receipt of a large number of orders which were unfilled in a prior year because of an interruption of production in such year, or the realization of windfall income from the sale of an obsolete stock of merchandise made possible by a temporary rise in demand. They may occur as a result of conditions within the taxpayer's industry, as for example where competitive practices of other members of the taxpayer's industry cause a diversion of a large portion of the demand to the taxpayer. Or they may occur as a result of unusually favorable business conditions affecting a large segment of business generally, as for example a sharp improvement in business conditions at the end of the taxpayer's base period stemming directly from the war.

The preparation or examination of any claim for relief will not be complete without an investigation of the possible existence of abnormally large income in the base period resulting from either abnormally high gross income or abnormally low deductions.

(F) Definition of an industry.

The necessity for discussing the concept "industry" arises primarily from the fact that under section 722(b)(3) the validity of a claim for relief depends, among other things, upon a demonstration by the taxpayer that the circumstances claimed as depressing its business also prevailed generally in the industry of which the taxpayer was a member. Thus, it is essential that the taxpayer demonstrate under section 722(b)(3)(A) that its profits cycle is substantially like the profits cycle for its industry (and that this differs from the profits cycle of general business); or under section 722(b)(3)(B), that its sporadic profits behavior is characteristic of its industry. Likewise, under section 722(b)(2) a taxpayer may show that the temporary economic conditions causing a depression in its business also affected its industry in the same manner. In this case, however, it is usually not so important to identify accurately the industry of which the taxpayer is a member since relief is not dependent upon the prevalence of the depressing conditions in the industry. The reference in section 722(b)(2) to the taxpayer's industry merely indicates that relief will not be withheld because the depressing influence was industry-wide.

It may also be necessary to identify the industry of which the taxpayer is a member as a step in the reconstruction of average base period net income in many cases other than those under sections 722(b)(2) and (3). Reference is often made hereafter to earnings of an industry during the base period as a source of information for determining the constructive average base period net income under section 722(b)(4).

In most general terms an "industry" comprises a group of business concerns sufficiently homogeneous in nature of production or operation, type of product or service furnished, and type of customers, so as to be subject to roughly the same external economic circumstances affecting their prices, volume and profits. Stated otherwise, an industry will generally consist of all of the producers which compete with each other in selling essentially the same products or services in the same market. General economic conditions external to the industry itself will be expected to affect the different competitors similarly if they are selling the same products in the same market, and it is this similarity of external conditions in the marketing processes which forms the basis of the concept of an industry for purposes of determining when an industry is depressed.

Thus, for the purposes of section 722, the definition of an industry involves primarily the market aspects of the taxpayer's business. In most cases the geographical location of the plants is immaterial. For instance, two companies producing shoes, one in New England and the other in the Middle West, may well be competitors and members of the same industry, since their customers in both cases cover the entire country. On the other hand, two concerns located 500 miles apart producing common brick may be subject to such different market influences, and be so distinct because of transportation costs, that they could not well be regarded as members of the same industry.

Under some circumstances it is conceivable that the geographical grouping of plants may have a bearing on what constitutes an industry. The cotton textile industry in the South has been subject during the last thirty years to developments quite different from those affecting the cotton textile industry in New England, and they are often considered as being two industries.

Large corporations that produce a variety of products may present considerable difficulty from the standpoint of industry classification. For example, a large chemical company may produce "heavy" chemicals, synthetic

textiles, and wood preservatives, among many other products. If a picture of the profits experience of the wood preservatives manufacturing industry were needed, it clearly would be improper to include therein the total profits experience of this company.

At the other extreme are large corporations that represent monopolies or partial monopolies in certain fields of production. Each such corporation, of course, must be regarded as constituting an "industry" by itself.

Difficulties may be anticipated in deciding whether the limits of a given industry should be broadly or narrowly defined. For example, in the retail grocery field, the problem will arise whether all retail outlets, chains and independents, supermarkets and suburban one-room stores should be grouped together or whether each type should be considered a separate industry. The answer depends upon the extent of which the several types are in direct competition and the degree to which they respond alike to economic factors that affect profits.

Part II

INTERRUPTION OR DIMINUTION OF NORMAL PRODUCTION, OUTPUT, OR OPERATION

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Law.—Section 722(b)(1).

Regulations.—Section 35.722-3(a) and section 35.722-2(b)(2).

(A) General rule.

In order for a taxpayer to obtain relief through the provisions of section 722(b)(1), it must be entitled to use the excess profits credit based on income and it must establish—

(1) That in one or more taxable years in its base period normal production, output, or operation was interrupted or diminished because of the occurrence of events unusual and peculiar in the experience of the taxpayer; and

(2) That *because* of such interruption or diminution its *actual* average base period net income is an inadequate standard of normal earnings; and

(3) The fair and just amount representing normal earnings to be used as a constructive average base period net income.

A taxpayer is not entitled to relief merely because it had an interruption or diminution of its production or operation. The interruption may have had no effect whatever on its actual average base period net income. Its production may have been interrupted without affecting its net income because of the existence of ample inventories to cover its needs during the period of interruption. Its normal rate of production may have been increased following the interruption so that production for the year or for the base period as a whole suffered no decrease. Its sales may have been curtailed for one taxable year during the base period because of the interruption, but due to the accumulation of unfilled orders its sales for the next base period year may have been above normal to an extent sufficient to overcome the deficiency in the prior year's sales. The interruption may have reduced volume of sales, but due to scarcity of the product and consequent increase in selling price the gross dollar sales may have been unaffected. In each case in which an interruption of production or operation is claimed as ground for relief, care should be exercised in determining that the interruption resulted directly in an inadequacy of actual average base period net income.

To illustrate, the bituminous coal strike of 1937 in the Appalachian coal field caused little or no decrease in the production of coal for the year. The coal inventories of the big industrial consumers were sufficient in most cases to carry them over the temporary stoppage of production. Because there was sufficient surplus capacity in the coal mining industry the lost tonnage was made up within a few months. The strike was expected to occur upon the

expiration of wage contracts on March 31, and consumers had been stocking coal for several weeks prior to that date. Thus, except in isolated cases, the production of bituminous coal companies in the year 1937 was not diminished by the strike.

(B) Scope of section 722(b)(1).

In order for an event to be considered under section 722(b)(1) all three of the following conditions must exist:

(1) The event must have occurred either immediately prior to or during the base period;

(2) The event must have been unusual and peculiar in the experience of the taxpayer;

(3) The event must have been the direct cause of the interruption or diminution of normal operation.

The use of the word "immediately" in the statute would ordinarily mean that the only events to be considered are those which occurred a short time prior to the beginning of the base period. However, the regulations give the word a broader interpretation and state:

> "An event is deemed to occur immediately prior to the base period if under normal circumstances the effect of such event would not be fully manifested until a year in the base period and such effect is directly related to such occurrence."

The point to be emphasized in this connection is, therefore, the causal relationship between the event and its effect on the operations during the base period.

For example, suppose one of the taxpayer's factory buildings was destroyed by fire in December, 1934. It started without delay to rebuild in January, 1935; the building was completed and machinery installed by December, 1935; but normal production could not be obtained until June, 1936. The fire will be deemed to have occurred "immediately prior to the base period" since it was the direct cause of the diminution in production during 1936.

Where a substantial period of time intervenes between the event and the base period, extreme care should be exercised in ascertaining the existence of the causal relationship between the event and the diminution in production.

For a discussion of events occurring during the base period but after December 31, 1939, see Part VIII relating to fiscal year taxpayers.

The events contemplated in section 722(b)(1) comprise primarily those which affect the physical rate of production or operation, rather than economic circumstances which influence the profitableness of the business. The regulations mention floods, fires, explosions and strikes. Other examples of similar events would be a severe freeze or blizzard, a crop blight or epidemic, or a temporary court injunction. The regulations exclude from section 722(b)(1) economic circumstances such as high costs, low selling price and low demand, any one of which could have resulted in an interruption or diminution of normal operation. Economic circumstances such as these should be considered under the provisions of section 722(b)(2).

Physical events such as are contemplated in section 722(b)(1) may give rise to economic effects which in turn cause an interruption or diminution of operations. In such cases it may be difficult to determine whether section 722(b)(1) or section 722(b)(2) is applicable. Ordinarily, it will not be necessary to make the distinction, since the taxpayer is entitled to relief in either case, provided the resulting inadequacy of average base period net income is established.

It should be noted that the statute uses the term "normal production, output, or operation." From the use of the word "operation" it is evident that the intention was to include taxpayers other than manufacturers and producers. Sales and service corporations, the operations of which were interrupted, are therefore included. Production, output, or operation refers primarily to those activities which produce the taxpayer's gross income, but also include collateral activities such as collections and credit.

The event must be unusual and peculiar in the experience of the particular taxpayer. The fact that such event is usual in the taxpayer's locality or usual in its industry is ordinarily irrelevant. However, if the taxpayer has been in existence only a short time prior to the event, it may be necessary to consider the experience of others in the locality or in the industry in order to determine whether the event is to be considered unusual and peculiar with respect to the taxpayer. Similarly, if an event is unusual in the case of the particular taxpayer, the fact that all taxpayers in the same locality or industry experienced the same unusual event does not bar consideration of the event under this subsection.

The term "unusual and peculiar" is to be given its ordinary meaning. The regulations state:

> "An event is unusual and peculiar in the experience of the taxpayer if its occurrence is not ordinarily encountered in such experience."

Cases involving this question may be classified into three groups. First, there will be those cases in which section 722(b)(1) is clearly applicable because the event has never before been encountered by the taxpayer or has happened at such infrequent intervals that its occurrence during the base period constitutes a clear distortion of average base period net income. At the other extreme will be those cases in which section 722(b)(1) is not applicable because the event is an ordinary and expected hazard of the business, occurring with such frequency that its presence is to be expected in any four-year period. Between these two extremes will be those cases in which the event is not unique in the taxpayer's experience but has occurred with such frequency or severity during the base period as to render the actual average base period net income an inadequate standard of normal earnings.

If the event causing the interruption was of such severity or duration as to constitute it a different kind of event, section 722(b)(1) should be considered applicable. For example, suppose the taxpayer's shipping operations were interrupted each winter for a period of two months by weather conditions. As a result of an unusually severe winter during the base period, its operations were interrupted or diminished for a period of four months, causing a substantial reduction in its average base period net income. If such a severe winter was unusual in the taxpayer's experience, its right to relief should be admitted under section 722(b)(1). In the reconstruction of average base period net income, however, adjustment should be made only to the extent that the effect on earnings exceeded the usual experience of the taxpayer.

The event may have been common in the taxpayer's experience, but may have occurred with more than usual frequency during the base period. For example, suppose that for fruit growers in a particular locality, a late spring frost damaging the crop is usually encountered every four or five years. If two such frosts of usual severity occurred during the base period, the unusual frequency renders section 722(b)(1) applicable. As in the case of an unusually severe event, adjustment should be made only to the extent that the unusual frequency exceeded the usual experience of the taxpayer.

(C) Reconstruction of average base period net income.

The reconstruction of average base period net income under section 722(b)(1) involves two problems:

(1) The elimination of the effects of the unusual and peculiar events, so that the net income for the base period years reflects the amount that would have been earned had such events not occurred; and

(2) The adjustment of abnormally high income in any of the base period years

(a) resulting from the unusual events causing the interruption, or

(b) resulting from any other unusual or peculiar circumstance,

so that a fair and just amount representing normal earnings will be obtained.

The elimination of the effects of the unusual events on base period net income requires adjustment not only of items directly affected, such as sales and direct costs, but also of overhead items affected indirectly by the events. Unusual expenses directly attributable to an event should be eliminated. For a discussion of deductions which are otherwise subject to adjustment under the provisions of section 711(b)(1)(H), (I), (J) and (K), see Part VIII relating to treatment of adjustments under section 711.

Sales, direct costs and overhead for the period of interruption should be reconstructed, if possible, by reference to the taxpayer's own experience before or after the interruption. Its experience immediately following the interruption may have been beneficially affected and therefore would be unreliable in determining what would have been normal during the period of interruption. Consideration should be given to average production or operation under normal conditions during various periods in the taxpayer's existence. Such averages, however, should be adjusted to conform to the business conditions prevailing during the period of interruption. Since the purpose is to eliminate only the effect of unusual and peculiar events and circumstances, the reconstruction of income under section 722(b)(1) must be made on the basis of normal conditions actually existing during the period of interruption. Such conditions include prevailing market demand, current selling prices, and existing costs of material and labor for the taxpayer's industry and business in general.

The experience of one or more comparable taxpayers may also be used in the reconstruction. For this purpose, the experience of the comparable taxpayers during the period of interruption must be adjusted to reflect the relationship existing between the taxpayer seeking relief and the comparable taxpayers. For example, suppose the taxpayer's sales during normal periods prior to the interruption were found to be approximately 20 percent above the average of the sales of three comparable taxpayers. A reconstruction of the taxpayer's sales during the period of interruption might be made on the basis of the average of the sales of the three comparable taxpayers increased by 20 percent for the same period. Care should be taken in such cases that the sales of the comparable taxpayers were not abnormally high during the period of interruption because of the taxpayer's temporary absence from the market.

As was pointed out above, events causing interruption of normal operations may have a beneficial effect upon a subsequent portion of the base period, partially or wholly offsetting the ill effects of the interruption. If the period adversely affected is adjusted upward to reflect normal operations, it is essential that any portion of the base period showing recoupment be revised

downward so that it also reflects normal operations. Evidence of any beneficial effect often may be found through an analysis of unfilled orders accumulated during the period of interruption and of expanded sales immediately thereafter.

In order to establish the fair and just amount representing normal earnings, it is also necessary to eliminate abnormally high income resulting from any unusual and peculiar events or conditions other than those causing the interruption. In this connection the regulations provide as follows:

> "Excess profits net income shall be considered unusually large in a taxable year in the base period only if, as the result of physical or economic circumstances unusual and peculiar in the case of the taxpayer, the income for such year is larger than it would have been if such circumstances had not occurred. Increased income due to circumstances which have affected business in general and which have caused an increase in the earnings of business in general, or due to circumstances which would not be considered unusual and peculiar in the experience of the taxpayer shall not be deemed to result in unusually large excess profits net income. If excess profits net income for a taxable year is determined to be unusually large, gross income and deductions shall be recomputed so as to remove the effect of the unusual circumstances in the computation of excess profits net income for such year."

For example, suppose the taxpayer's normal operation of a hotel property was interrupted during 1938 by a fire, which substantially reduced its gross income from room rent in that year. Because of a "World's Fair" in 1939, (an event unusual in its experience) its gross income from room rent was abnormally high. For the purpose of determining the constructive average base period net income, adjustment must be made for both years in order to eliminate the effect of the fire and the "World's Fair." Careful investigation and adjustment should also be made of any increased earnings realized in any base period year as a result of interruption or depression of any competitor hotel's business by reason of such factors as reconstruction or remodeling of its building, strikes or boycotts.

It should be emphasized that the adjustment contemplated by the regulations does not include elimination of income due to more favorable *general* business conditions.

For a discussion of the growth formula under section 713(f) and the deficit or 75 percent rule under section 713(e)(1) in relation to the constructive average base period net income, see Part VIII(E) relating to these rules.

In order for a taxpayer to be entitled to relief under this paragraph of section 722, it must clearly establish the effect on its earnings of the interruption of operations. It is not sufficient to show that an event such as a strike or fire occurred and that a year in the base period showed low earnings or a net loss. The taxpayer must submit information showing how its earnings were affected and the extent of the adverse effects. Furthermore, in the reconstruction of average base period net income, it must show what earnings would have been realized had the interruption or diminution not occurred. The mere substitution of average earnings of some other period in the taxpayer's existence, or the unsupported statement that its earnings would have been a flat percentage of its gross sales will not be sufficient. Enough supporting information must be furnished to show that the earnings used in the reconstruction represent a fair and reasonable measure of what would have been earned had the interruption not occurred. Particularly helpful would be a compilation of the taxpayer's earnings and a history of its interruptions of production covering a considerable period, say 10 to 15 years, prior to the base period.

Part III

TEMPORARY ECONOMIC DEPRESSION

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Law.—Section 722(b)(2).

Regulations.—Section 35.722-3(b).

(A) General rule.

In order for a taxpayer to obtain relief through the provisions of section 722(b)(2), it must be entitled to use the excess profits credit based on income and it must establish—

(1) That in one or more years of the base period its business was depressed because of temporary economic circumstances unusual in its experience, or because the taxpayer's industry was depressed by reason of temporary economic events unusual in the industry; and

(2) That *because* of such temporary depression its *actual* average base period net income is an inadequate standard of normal earnings; and

(3) The fair and just amount representing normal earnings to be used as a constructive average base period net income.

A taxpayer is not entitled to relief merely because its business was depressed in the base period or its net income was smaller during the base period than in some earlier period, long or short. Even if the net income in one or more years of the base period was adversely affected by economic events or circumstances, it must be shown that these conditions were both temporary and unusual. If the depressing influences were otherwise than temporary, the taxpayer or its industry could be characterized as a declining business or industry; a new lower level of normal earnings would then have been established by reason of these circumstances and the actual average base period net income would not be an inadequate standard of normal earnings for comparison with earnings during an excess profits tax taxable year. If the economic circumstances causing the depression were not unusual, either in the experience of the taxpayer or of its industry, then again the actual average base period net income of the taxpayer cannot be considered to be inadequate.

The statute in section 722(b)(2) refers to the business of the taxpayer being depressed "in the base period", whereas in section 722(b)(1) it refers to an interruption or diminution of production, output, or operation "in one or more years of the base period." It might be urged that the language of section 722(b)(2) requires a depression of the taxpayer's business throughout the base period in order to qualify; but this position is inconsistent with two of the illustrations given in the Congressional committee reports, one where a taxpayer lost its principal customer "during the base period", and one where a taxpayer belonged to an industry which experienced a ruinous price war "during several of the base period years." It is therefore the position of the Bureau that the difference in the language of section 722(b)(1) and (2) is not signifi-

cant, and that a depression due to temporary economic circumstances does not have to apply to the entire base period in order to be valid as a basis for relief under section 722(b)(2).

The term "economic" includes any event or circumstance, general in its impact or externally caused with respect to a particular taxpayer, which has repercussions on the costs, expenses, selling prices, or volume of sales of either an individual taxpayer or an industry. Thus, not every event or circumstance which has an adverse effect on a taxpayer's profits may serve to qualify that taxpayer for relief under subsection (b)(2). First, the temporary and unusual character of the circumstance or event must be clearly established. Second, the cause of the temporary depression must be shown to be external to the taxpayer, in the sense that it was not brought about primarily by a managerial decision. A taxpayer cannot qualify for relief under subsection (b)(2) because its earnings were temporarily reduced in the base period in consequence of its own business policies, internally determined. For example: The X paper manufacturing company customarily obtained its pulpwood by contracting with pulpwood suppliers on a quarterly basis, the delivered price being negotiated anew in connection with each quarterly contract. For the season of 1937-1938, however, the manager contracted for the delivery of the entire year's supply of pulpwood at a fixed price. A sharp decline in the price of delivered pulpwood occurred near the end of the first quarter of the season, but the X company was unable to abrogate its season-long contract. Consequently, its profits were temporarily reduced because of the high cost of its raw material. Nevertheless, it does not qualify for relief under this subsection since the reduction in its profits was primarily attributable to a managerial decision.

In order for the depression of the business of a taxpayer to come under section 722(b)(2), it is not necessary that the taxpayer's earnings be reduced to any particular level, nor even that they be less than the average for the taxpayer's industry. It is necessary only that they be less than they normally would have been for the taxpayer in the absence of the temporary economic circumstances shown.

Section 722(b)(2) differs from section 722(b)(1) in that the latter deals with events that produced an interruption or diminution in production, output, or operation, whereas section 722(b)(2) may be applicable where there was no decrease in the volume of operations, but merely a decline in net income through decreased selling prices, increased costs, or increased operating or general expenses. For example, the same basic cause might lead to a section 722(b)(1) claim in the case of one taxpayer and a section 722(b)(2) claim for another. The New England hurricane interrupted the operations of a taxpayer whose building was demolished or whose power lines were destroyed; it caused a temporary economic depression of another taxpayer's business whose customers were impoverished or the businesses of whose customers were disturbed.

(B) Scope of section 722(b)(2).

Since the economic circumstances giving rise to relief must be temporary and unusual, it is important that the taxpayer furnish evidence concerning the exact nature of the circumstances alleged. It is not sufficient that the taxpayer merely show a depression during the base period by comparing its earnings during this period with earnings in a prior period, accompanied by general allegations concerning hard times or unfortunate conditions. It is expected that for all industries and all taxpayers there will be fluctuations from year

to year in their earnings experience. Such fluctuations are perfectly normal, and in fact occurred in the experience of corporations generally during the base period. The year 1938 was in general a year of poor profits, and it would be improper under section 722(b)(2) to grant relief due to that fact. In some particular industries one or more of the other years of the base period were depressed because of usual and recurring circumstances. Thus, it is necessary that the circumstances alleged under section 722(b)(2) be identified specifically as to character, causes, extent and severity, and that positive evidence be presented to show that they were both peculiar and temporary.

This requirement of showing that the events are unusual and temporary means that the taxpayer must present evidence concerning the years prior to the base period. Sufficient study of the taxpayer's business and industry must be made to establish that the alleged causes of the depressed earnings, and not some other circumstances which would not qualify under this subsection, were in fact the actual causes.

For instance, a circumstance in 1938 might be alleged to be the cause of poor earnings in that year, whereas the true cause might well be the general decline in business of most industries and the drying-up of consumers' purchasing power in that year. Study of prior industry experience might well show that a circumstance claimed to be unusual and peculiar—a price war, for instance—might be a fairly regular and expected occurrence in the industry during depression years.

A note of caution is necessary concerning the temporary character of the circumstances. The mere fact that the circumstance which occurred during the base period has continued into the excess profits tax taxable years is not evidence of the permanent character of such circumstances. As stated in the regulations, "An economic circumstance is temporary depending upon the character and nature of such circumstances rather than upon the mere length of time of its existence." For instance, if the Japanese invasion of China interfered with the flow of raw materials to a business during the base period, the fact that the interference is still in existence does not remove the circumstance from the category of being temporary.

On the other hand, the fact that the war has removed a depressing circumstance does not put this circumstance into the category of being temporary. For instance, artificial ice companies are members of an industry which was declining before and during the base period. The fact that the growth of a war industry in its locality brought a large increase in patronage to an ice company in an excess profits tax taxable year does not cause the declining character of the industry to be any less permanent. The actual average base period net income of such an ice company, even though substantially smaller than its average income in some prior period, is not an inadequate standard of normal earnings merely because subsequent events have temporarily reversed the trend of earnings.

An unusual combination or concurrence of usual conditions may of itself constitute an unusual event or condition under section 722(b)(2). For instance, a taxpayer's business may have been depressed during the base period because of an unusual combination of temporary economic circumstances, no one of which was unusual or would have abnormally depressed the business if existing alone.

Economic events which will or will not qualify as a basis of relief under section 722(b)(2) may be illustrated as follows:

(a) A brush manufacturing company which normally imports most of its bristles from China suffered an impairment of its business and earnings during the base period because of the Japanese invasion of China in 1937. It had to seek elsewhere for its raw material and accept inferior substitutes at higher prices. This interruption of raw material supplies constitutes a temporary economic event affecting the taxpayer and its industry which would be recognized under section 722(b)(2).

(b) A taxpayer selling luxury goods, and having a substantial proportion of its customers located in the area devastated by the New England hurricane of 1938, suffered a temporary loss of patronage because of the financial hardships inflicted by the catastrophe on its patrons. This situation constitutes a temporary and unusual economic circumstance under section 722(b)(2) if it be shown that the patronage was actually lost, and not merely postponed until 1939 when delayed orders were added to the normal volume.

(c) On the other hand, a taxpayer claims relief under section 722(b)(2) because of the alleged absorption during the base period of the burden of certain "temporary" excise taxes placed upon the sale of cosmetics. Even if the taxpayer could prove the absorption of these taxes, and the resultant depressing effect on its income, this would not qualify as a basis for relief. Taxes of all kinds are normal charges to which businesses are subjected, and they normally vary in duration and rates.

(d) A taxpayer engaged in the importation of lace alleges a temporary depression during the base period because of certain temporary changes in the tariff rates covering its products. Certain increases in tariff rates caused a shift in the price structure and thus reduced the volume of business. This alleged basis for relief must also be rejected since changes in tariff rates are one of the normal hazards in the importing business.

(C) Reconstruction of average base period net income.

The reconstruction of the average base period net income under section 722(b)(2) will often proceed along lines closely similar to the methods described under section 722(b)(1). See Part II, paragraph (C). Especially if the temporary economic circumstance affected only the taxpayer and not its industry, these methods will be used with little change. The same two problems are involved:

(1) The elimination of the effects of the temporary economic circumstance, so that the net income for the base period years reflects the amount that would have been earned had such circumstances not occurred; and

(2) The adjustment of abnormally high income in any of the base period years,

(a) resulting from the temporary economic circumstances serving as the basis for relief, or

(b) resulting from any other unusual or peculiar circumstance,

so that a fair and just amount representing normal earnings will be obtained.

If the temporary economic circumstance affected the taxpayer's industry as well as itself, then the problem of eliminating its effects is more difficult. In this case, of course, reconstruction cannot be made by reference to the

experience of comparable taxpayers in the industry. As suggested in the regulations, reference may be had to prior normal periods in the experience of the taxpayer and its industry, or in some cases perhaps to other industries which are otherwise similar to the taxpayer's industry but uninfluenced by the circumstances involved.

In all cases under section 722(b)(2) reconstruction is made on the basis of hypothetical economic conditions presumed to have existed in the absence of the temporary and unusual depressing conditions. These hypothetical economic conditions may depart from the actual conditions only to the limited extent of the correction for the circumstances shown to be unusual. If general business conditions were depressed, as was the case in most industries in the year 1938, this situation must be maintained in the hypothetical circumstances under which normal earnings are reconstructed.

Part IV

VARIANT PROFITS CYCLE AND SPORADIC PROFITS EXPERIENCE

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Law.—Section 722(b)(3)(A) and (B).
Regulations.—Section 35.722-3(c)(1) and (2).

(A) General rule.

In order for a taxpayer to obtain relief through the provisions of section 722(b)(3), it must be entitled to use the excess profits credit based on income and it must establish—

(1) That the business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in an industry of which the taxpayer was a member, subjecting such taxpayer to

(i) a profits cycle differing materially in length and amplitude from the general business cycle, or

(ii) sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period, and

(2) That *because* of either condition its *actual* average base period net income is an inadequate standard of normal earnings; and

(3) The fair and just amount representing normal earnings to be used as a constructive average base period net income.

The basis for relief under section 722(b)(3) is quite different from that which qualifies a taxpayer under section 722(b)(1) and (2). Thus, in order to meet the first qualification for relief under section 722(b)(3), the taxpayer must show that the inadequacy of its base period net income is due to conditions *ordinarily* existing and *characteristic* of its industry. These industry conditions must not be of a temporary or abnormal nature, as in section 722(b)(1) and (2), but must be inherent in the typical behavior of the profits in the industry. Under section 722(b)(3)(A) the taxpayer must demonstrate that the industry of which it is a member normally experiences a cyclical pattern of profits of such a character that the average profits realized by the industry during the statutory base period differed markedly from the profits experience of business generally, and therefore is not a fair representation of the taxpayer's normal profits. Under section 722(b)(3)(B), the taxpayer must show that its industry characteristically has a profits behavior involving isolated periods of high production and profits occurring at irregular intervals, and that such periods were not represented, or were inadequately represented, in the statutory base period. Inadequate representation of such periods occurs when either their frequency or extent during the base period was less than is, on the average, normally encountered.

Because of the circumstances upon which relief under section 722(b)(3) is predicated, the experience of the taxpayer and its industry over a longer or different period of time than is covered by the statutory base period must be considered both in determining the existence of the qualifying depression and in reconstructing average base period net income. Under sections 722(b)(1) and (2), the need for relief stems from some abnormality occurring in the base period, such as an interruption of production or a temporary economic depression. Under section 722(b)(4), the need for relief stems from a change in the character of the taxpayer which occurs during or immediately prior to the base period. In contrast, under section 722(b)(3) relief is needed because the base period itself is unrepresentative of normal experience because of circumstances peculiar to the taxpayer's industry. Normal income in such cases can never be determined merely by reference to the statutory base period. Prior experience must always be studied. The manner in which prior experience should be used as a guide in the determination of normal earnings in a section 722(b)(3) case will be discussed below in the sections on reconstruction.

(B) Proof of a variant profits cycle.

The term "business cycle" refers to the more or less regular, recurring fluctuations of business activity. The cycle is ordinarily represented graphically by historical line charts of profits, prices, production, employment, bank clearings, or other indicators of "good" and "bad" times, either taken singly or in combination. The resulting "curves" present a picture of up and down movements of business over long periods, which movements tend to be repeated at more or less regular intervals and thus to fall into a cyclical pattern. The length of the cycle is the period of time between corresponding stages of two successive cycles. The amplitude of the cycle refers to the violence of fluctuation and is measured by the vertical distance between high and low stages.

As has been indicated above, various indicators of business activity may be used to represent the business cycle. Ordinarily the determination of which indicators most accurately represent the cycle is made in the light of what is to be measured or compared. Therefore, for purposes of section 722 the general business cycle must be defined as the profits cycle of all corporations. The statutory reference in subsection (b)(3)(A) to a profits cycle for the taxpayer and its industry "differing materially in length and amplitude from the general business cycle" would be meaningless unless things of like nature were being compared, namely profits cycles. If the base period income of the taxpayer was depressed because of the fact that the taxpayer's cycle and that of its industry were in a different phase in 1936-1939 than was the general business cycle, due to a difference in length and amplitude, then the taxpayer may reconstruct its base period income under section 722(b)(3)(A).

It follows from the nature of the relief provided for by section 722(b)(3)(A) that few taxpayers will be able to qualify under its provisions. The operations of most industries are so interrelated, and their profits so dependent upon the purchasing power of other industries and consumers, that there will be few industries which, for the base period as a whole, will have been depressed because they operated at a significantly different phase of a profits cycle than did corporate business generally. The earnings cycle of most taxpayers will tend to conform to the general business cycle rather than to vary materially from it.

To meet the test of having a variant profits cycle the taxpayer must present substantial evidence that its profits follow a cyclical pattern differing markedly from the profits cycle for business generally. Second, it must show that the variance of its cycle is due to conditions generally prevailing in the industry of which it is a member. As a practical matter, this means that the taxpayer must demonstrate that the profits of its industry follow a cyclical pattern differing from the profits cycle of all corporations, and that the taxpayer's cycle follows closely that of its industry. Therefore, generally the taxpayer must submit three sets of cyclical data covering (1) its own profits, (2) profits of its industry, and (3) profits of business generally. The sources of the data should, of course, be given and the method of compilation examined. In addition, the data must be subjected not only to the usual verification for accuracy, but, more important, for the meaning, significance and comparability of the figures themselves.

In order to lay the basis for an application of the test outlined above, painstaking consideration must be given to the nature of the general business cycle. The fact that economic activities are subject to recurring phases of contraction and expansion is the primary and elementary basis for the business cycle concept. The concept becomes complete, however, only on the assumption that the recurrence of phases of prosperity and depression have economic causes which inevitably operate to reverse the trends of economic activity and thus result in an undulating pattern of production, prices, sales and profits.

Although all industries are subject to the broad economic forces which affect business generally and which are considered to be cyclical forces, it does not follow that the profits of an individual industry will follow the composite pattern of all business. The earnings of an industry may vary from those of all business for two reasons, only one of which will result in a variant profits cycle.

First, a particular industry may be subject to special, peculiar and nonrecurring influences which in the short run depress or stimulate its earnings without affecting business generally. An extreme example would be an industry dependent upon consumer fads or fashions. Localized industries might be non-cyclically influenced by a spectacular land boom perhaps extending over several years. An industry might be required by law to install comprehensive safety devices and practices which might for a time reduce its profits and at the same time increase the earnings of the manufacturer which supplied the devices it was required to install. All of the above circumstances and many others might temporarily distort the earnings of a given industry out of all resemblance to the average earnings of all industry. This distortion would not, however, create a variant profits cycle. It would not in fact change the cycle of the industry at all because it would not influence the characteristic or long-run pattern of earnings. Such circumstances would not, therefore, result in a base period depression leading to relief under section 722(b)(3)(A) although, of course, a member of an industry affected by factors illustrated above might or might not qualify under some other paragraph of section 722(b).

Second, a particular industry might be so constituted as to respond differently than general business to factors constantly affecting all business and, therefore, considered to be cyclical. An extreme example of this situation is offered by the so-called "depression" industries, i. e., those which tend to be most prosperous when average earnings of all business are low. For instance, the earnings of certain types of small loan companies typically and characteristically run counter to those of all business for the reason that borrowers

require fewer small loans in generally prosperous periods than in periods of depression. Another example of this sort might be found in industries supplying substandard, low priced, consumers goods which are in relatively greater demand in periods of depression. More important from the standpoint of section 722, however, are those industries which, because of the nature of their operations, characteristically lag behind general business in the recovery phase of the business cycle. For example, manufacturers of certain heavy machinery used in the production of consumers goods may typically experience a falling off of orders and earnings coincident with a major recession in general business earnings. The same relationship between earnings of such manufacturers and those of general business does not hold on the recovery phase of the cycle because orders for new manufacturing machinery of such types are characteristically deferred until sustained demand and sales for consumers goods are established. This results in a substantial lag in earnings for the machinery manufacturer as compared with general business. Such variations from the general business cycle as are illustrated above are cyclical because the variations are based on rational and characteristic relationships between the cycle of a particular industry and that of general business.

The existence of the general business cycle has been established only by the observation of the various long-time historical series of data which measure economic activity. It follows that the existence of a variant cycle for a taxpayer or an industry should be established in the same way, i. e., by the observation of a sufficiently long history of profits behavior to encompass two or more cycles in order to demonstrate the *characteristic* behavior of the profits of the taxpayer and its industry, and that the variations from the experience of general business are due to cyclical causes. But this second proposition encounters practical difficulties at the outset. Many taxpayers, and even many industries, came into existence or radically changed their nature after 1920 so that their whole pre-war life span is encompassed by the relatively short period of 20 years. Furthermore, even in those industries which have a long and relatively unchanged experience, earnings data back of 1920 are spotty and unreliable, and the experience during and immediately after World War I can scarcely be considered as normal.

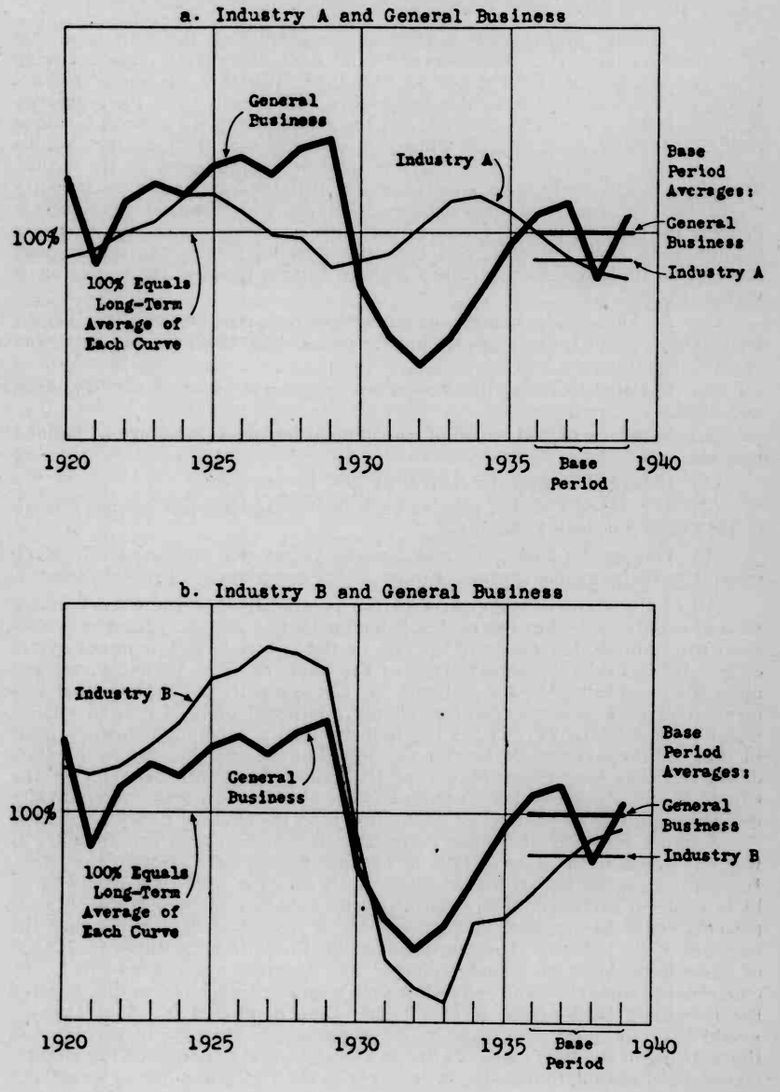
In this practical dilemma it is believed that the only workable and equitable rule is as follows:

1. If the experience of the taxpayer's industry is sufficiently long to cover two or three of its major cycles, the variance of the industry cycle from the profits cycle of all corporations may be established solely by reference to the profits history of the industry and of business generally.

2. If the experience or available data of the taxpayer and its industry are too limited to reveal the characteristic behavior of profits, the taxpayer will not necessarily be denied relief. However, in such circumstances the burden of proving that the taxpayer's earnings were depressed in the base period because of a variant profits cycle is greatly increased, since the taxpayer must establish the existence and nature of its cycle by inferential rather than by direct evidence.

It is believed that the application of the above rules can best be shown by the following examples which necessarily are over-simplified.

Figure 1. VARIANT PROFITS CYCLE INDUSTRIES



Case 1. Suppose that a taxpayer's industry experienced two complete and regular cycles in the period 1920-1939 as, for example, Industry A in Figure 1-a.

The industry profits cycle illustrated is so strikingly different from that of general business that no observer would have difficulty in characterizing it as variant, at least for the period 1920-1939. Whether the same variance would hold for other periods is immaterial in such a case, since the regularity of the industry cycle is so marked, and the correlation with general business profits so lacking, as to suggest almost conclusively that the industry's profits cycle of the 20-year period is characteristic of and inherent in its nature. Therefore, subject only to the qualification that in the base period the industry might have encountered identifiable conditions which would permanently depress its earning power as compared with past experience, the taxpayer belonging to such industry, and having a parallel profits experience, may reconstruct its base period earnings without further proof of the causes of its variant cycle.

Case 2. This is a less simple example than the preceding one (see Figure 1-b). The cycle of Industry B, during the period 1920-1939, differed from that of all corporations as follows:

(a) It failed to follow the recessions in general business of 1924, 1927, and 1938.

(b) It led, or moved ahead of, the general business downturn of 1929 by two years.

(c) It lagged behind the revival of 1933 by one year.

(d) It reached a higher relative peak in 1927 and a lower relative trough in 1933 than did general business.

(e) During the base period as a whole it had not recovered to a level, relative to its long-time average, similar to the experience of general business.

All of the above is suggestive of the possibility that Industry B has a variant profits cycle, but the profits behavior for the 20-year period is insufficient to establish that the lead, the lag, or the failure to follow minor cycles of general business is characteristic of the industry. The period covers not more than one full cycle for Industry B. Consequently, a taxpayer that is a member of such an industry must supply additional proof if it is to qualify under section 722(b)(3)(A). If the industry had a substantial history prior to 1920 the taxpayer might be able to show that the one year lag in the start of its recovery was characteristic of its industry's profits behavior at the trough of major depressions. It might also be able to show a characteristically greater amplitude or violence of fluctuation than the cycle of general business.

Assume, however, the much more difficult situation in which Industry B was not in existence prior to 1920 or had insufficient data prior to that time. In such a case the actual historical earnings data for 1920-1939 would be of little value in establishing the characteristic behavior of industry profits. It perhaps could be established on the basis of historical data alone that the earnings of the industry characteristically failed to follow the minor recessions of general business previously referred to. But this proof would be of no consequence since the failure to follow such minor recessions favorably affected the industry's base period income rather than depressed it. The taxpayer would have to show, first, that its disproportionate increase in earnings on the upswing of the 1920's was not due to any abnormal or nonrecurring circumstances, and second, that its lag in recovery in the 1930's was due to something

inherent in its industry, e. g., the nature of its product, the buying habits of consumers, or some like circumstance. In other words, in the absence of adequate historical proof it would have to show that the variation in its profits was due to a rational and characteristic relationship between its cycle and that of general business.

Up to this point there has been no discussion of the primary qualification for relief under section 722(b)(3)(A)—namely, that earnings of the taxpayer must be shown to have been depressed in the base period. This determination requires a comparison of the taxpayer's base period earnings with those of a longer period. The period 1922-39 will generally be the most appropriate longer period to use in making such a comparison. This is for the reasons (1) that the period 1922-39 includes the most recent periods of major prosperity and depression, (2) that the level of corporate profits throughout such extended period was approximately the same as the average of corporate profits during base period years, (3) that this period is relatively free from any drastically abnormal influence such as war, and (4) that more complete data are available for this period than prior periods. If this long-term average is to be taken as normal, however, there must be excluded any years during which identifiable non-cyclical circumstances caused the income of the taxpayer to be abnormally high or low. Furthermore, regard must be had to significant changes in the character of the taxpayer or its industry in the long-term period. If, for example, the industry of the taxpayer doubled or halved in size during the extended period, some adjustment would have to be made for this circumstance before long-time earnings could be used. An obvious adjustment would be to compute a ratio of earnings to capacity. This would, however, be unsuitable in many industries and in any case would constitute only a rough correction for the changing size of an industry or a taxpayer. In proper cases a ratio of aggregate net earnings to total assets, capital assets, or net worth, taken alone or in combination, may afford a basis for adjustment of long-time earnings to income in the base period.

(C) Variant profits cycle—Reconstruction.

(1) In reconstructing base period net income of a taxpayer under section 722(b)(3)(A), the period will be considered as a whole rather than by individual years. This is necessary since, as discussed above, the nature of the inadequacy is the unrepresentative character of the base period as a whole. The reconstruction will take the form of finding the average income of the taxpayer for another series of years than the base period which can be considered as normal. (See Part VIII relating to adjustments under section 711 for a discussion of the reconstruction of the individual base period years in the case of 1940 relief claims for purposes of computing the income taxes which would have been applicable to the reconstructed incomes.)

In ascertaining the income of the taxpayer in other years it is desirable, in general, to use data conforming as nearly as possible to the definition of excess profits net income, making any necessary adjustments to exclude capital gains and losses, tax-exempt income, dividends received from domestic corporations, etc. The first step in the analysis of such data should invariably be to make a chart or graph of this net income, if possible back at least to 1922. Wherever in the following description reference is made to average base period net income the term means the simple arithmetic average of the annual incomes, deficits included, rather than the statutory average base period net income as defined in section 713, which may reflect the application of the growth formula, deficit rule, or 75 percent rule.

(2) If it is possible to identify a limited period or periods prior to the statutory base period when profits were normal for the taxpayer and its industry (see Regulations, sixth paragraph under section 35.722-3(c)(1)), then the average rate of profits during such period or periods can be used as the basis for reconstructing normal earnings. For this rate of profits, it may be proper to employ the annual earnings in dollars, or it may be desirable to use some form of ratio to total assets, capital assets or net worth, as discussed above. One or more of these ratios may be of especial value in case the taxpayer has changed materially in size during the period under consideration.

Great caution should be exercised, however, in the use of any selected period of a few years as representing a period of normal profits for a taxpayer. Some taxpayers have asserted that the period of 1926 to 1929, or 1925 to 1930, represents for them a period of normal earnings. Only in rare instances, if ever, could such a position be substantiated, in view of the fact that for most industries this period of years represented the peak of the most prosperous period in recent history. Taken alone, without a corresponding period of depression, these years cannot in any sense represent a period of normal earnings.

(3) In most cases it will be impossible to select, on an objective basis, any limited period of a few years prior to the statutory base period when profits are normal for the taxpayer or its industry. Usually, it will be necessary to use the experience of the taxpayer and its industry for an extended period covering one or more complete cycles, including the base period as well as prior years. Since the objective is to determine normal earnings by taking into account both periods of high and low earnings, care must be exercised to have the extended period include one or more complete cycles. If the selected period were to include one complete cycle and part of a preceding cycle the result would be to give undue weight to the portion of the cycle thus duplicated in the extended period.

In selecting the extended period it is therefore necessary first to identify the stage in the cycle reached by the taxpayer and its industry at the end of the base period. A similar stage in the first, second or third preceding cycle is then selected as the starting point of the extended period to be used for this purpose. If the curve of profits for the taxpayer and its industry appears to be near its peak or trough at the end of the base period, it will be a relatively simple matter to identify the prior points corresponding with this position, since these will be at or close to the turning points. If, on the other hand, at the end of the base period the position of the taxpayer and its industry appears to be nearly midway in the expansion or contraction phase of the cycle, it may be more difficult to determine precisely the equivalent point in the prior cycle. In this case, however, it is not necessary to identify the exact year when the profits of the taxpayer and its industry reached a corresponding position because, since this position is at about the average of the peaks and valleys, the use or discarding of one or two debatable years at the beginning of the period to be considered will have a negligible effect upon the average which is to be obtained. If it is clearly impossible to determine within fairly close limits the stage of the alleged cycle reached at the end of the base period, and to identify the similar point in a previous cycle, then this fact is strong evidence that the taxpayer and its industry are not cycle cases and cannot qualify for relief under section 722(b)(3)(A).

As suggested above, it is usually desirable to limit the extended period chosen to years subsequent to 1921, although profits in years prior to that time may be

examined as an aid to identifying the stage in the profits cycle reached at the time chosen as the beginning of the extended period. It is likewise emphasized that the base period years must be included in the extended period as part of the cycle experience, since the basis for relief is the extent of the depression in profits during the base period resulting from the cyclical behavior of profits, and the base period itself is a part of the cycle.

(4) Having determined the extended period which will be used as representing the normal experience of the taxpayer, its average rate of profits should be determined for this period, using for this purpose the type of data employed under paragraph (2) above. The complete experience of the taxpayer during this extended period should be employed, subtracting the sum of any deficits from the sum of the net incomes, and dividing by the number of years represented. The inclusion of deficit years in the average follows from the fact that in cases which can qualify under section 722(b)(3)(A) all periods (with the exception of all years in the extended period when temporary and abnormal events influenced profits upward or downward) are considered as a part of the normal profits experience of the taxpayer. In the very nature of the case, deficits in some periods may be just as normal as high earnings in others.

To illustrate the method of reconstruction, assume that the eighteen-year period 1922-1939 has been selected to represent the period of normal earnings for the taxpayer and its industry and that, because of changes in the size of the taxpayer's business during this period, it is advisable to use the annual ratios of net income to net worth. The average of these 18 ratios (deficits included) is then obtained for the taxpayer. Assume that this average rate of return for the extended period was 11 percent.

(5) The next step is to compute the corresponding average earnings for the taxpayer during its base period on the same basis. Continuing the illustration, assume that the average base period ratio of net income to net worth is found to have been 6 percent.

(6) A comparison of these averages shows the extent by which the taxpayer's earnings during the base period were depressed below normal. The comparison may usually best be shown by the ratio: $\frac{\text{base period average}}{\text{extended period average}}$.

In the illustration given this results in $\frac{.06}{.11} = .555$, showing that base earnings were only 55.5 percent of normal.

(7) This does not prove conclusively, however, that the taxpayer's earnings were depressed by this amount *due to a variant profits cycle* for itself and its industry. In addition to a depression because of a variant profits cycle, the taxpayer may have been losing out in the competitive race in its industry, or there may have been one or more years of subnormal income in the base period due to a factor which will qualify the taxpayer for relief under section 722(b)(1) or (2).

In general (subject to certain exceptions noted below), the *variant cycle* depression of a taxpayer during the base period cannot exceed materially the degree of base period depression experienced by the industry of which the taxpayer is a member, since by definition cyclical influences are industry-wide rather than individual in their incidence. Thus, it is necessary for the taxpayer to show, with the degree of accuracy that is practicable, the extent of the cycli-

cal depression of earnings suffered during the base period by its industry. If earnings data for a representative group of corporations in the industry are available, the degree of depression may be computed in a manner similar to that shown above for the taxpayer, care being taken that the earnings for individual corporations are represented in the industry average in proportion to the relative size of the corporations in the industry. This relative size may be shown by volume of sales, capital investment, net worth, or some other measure appropriate to the industry.

In comparing the degree of depression for the taxpayer with that of its industry, it must be remembered that the data for the industry represent only an average of the experience of many corporations, and show only to a degree of approximation the "true" cyclical picture of the industry. Thus, a slight divergence of the result of the above computation for the taxpayer from that for its industry would be without significance. But if the data for the industry should indicate base period earnings of 85 percent of normal, compared with the taxpayer's 55.5 percent of normal, the need for further scrutiny is indicated.

It is possible that the divergence may not indicate any difference in the cycles of the taxpayer and its industry, but only a difference in the impact of the cycle on the taxpayer. For example, if the taxpayer customarily carried inventories substantially in excess of the average of taxpayers generally in its industry, the cyclical fluctuations, and thus the degree of depression, in the taxpayer's profits would normally be greater than those for its industry. This might explain the discrepancy found in the illustration given above. Or it might be demonstrated that the impact of the depression was more severe in a segment of its industry represented by the taxpayer than in its industry as a whole. Any such contentions must, of course, be demonstrated rather than merely alleged.

It is recognized that in some cases it will be impracticable to measure with accuracy the degree of cyclical depression of profits suffered by the industry of which a taxpayer is a member. For instance, the industry may consist solely of small, closely-held corporations which never publish financial reports. Or there may be no trade association, or the existing trade association may never have gathered earnings data. This, however, does not relieve the taxpayer of the burden of showing by appropriate means the facts requisite to proof. If pertinent and reliable profits data cannot be obtained, substitute data may be employed to demonstrate the nature of the profits cycle of the taxpayer's industry and the degree of depression suffered in the base period. Such substitute data might be sales in either physical or dollar terms, quantity of raw materials consumed, power purchased, employment, or wages paid—any data showing satisfactorily the cyclical movements of the business of the taxpayer's industry.

In summary, adequate evidence of some type must be presented to show what part of the profits depression of the taxpayer's business (55.5 percent in the example given above) represents depression for which relief may be granted under section 722(b)(3)(A) (or one of the other paragraphs of section 722(b)) in contrast with that part of the taxpayer's profits depression which may be the result of permanent or usual factors which do not entitle the taxpayer to relief.

(8) The final step in reconstruction is to adjust the average base period net income of the taxpayer to the normal base period level by applying the ratio found in step (7), which ratio represents the degree of the taxpayer's cyclical depression. Suppose that in the example above it appears on examination of

the pertinent evidence that the industry depression figure of 85 percent understates the profits cycle depression of the taxpayer, but that the taxpayer's figure of 55.5 percent includes an element of depression due to factors not entitling it to relief under section 722. Assume that 75 percent has been shown to represent the degree of *cyclical* depression of the taxpayer's net income.

Suppose further that the actual income of the taxpayer in the base period averaged $60,000. Then the constructive average base period net income of the taxpayer is $\frac{\$60,000}{.75} = \$80,000.$

(9) Many special problems are bound to arise in individual cases which cannot be covered in a general bulletin. The investigation must be adapted to the circumstances of the taxpayer and the data reasonably available. If the taxpayer has not been in business over a period long enough to determine its own cyclical profits experience, it is a matter of judgment how rigorous should be the proof required to demonstrate the similarity of its profits experience with that of the industry to which it purports to belong. Statistical and accounting data are by no means the only type of evidence to be employed in such cases. Comparison of the general circumstances of the taxpayer with those of other comparable taxpayers similarly situated which have been in business for a longer time may be pertinent. Having carefully established the industry to which the taxpayer belongs, profits data for comparable concerns and for this industry can be used in lieu of the taxpayer's data prior to its commencement of business.

(10) It will be observed that in the reconstruction of average base period net income under section 722(b)(3)(A), the normal income for a taxpayer is usually considered to be its average income (including deficits) over a period longer than the base period. In general, the 18-year period from 1922 to 1939 is recommended. It has been suggested that normal income for purposes of section 722(b)(3)(A) should not be this long-time average, but an amount higher than this by the same percentage that the profits of business generally in the base period allegedly exceeded average profits in a longer series of years. It is asserted that the official data for the Bureau of Internal Revenue published in the annual "Statistics of Income" reveal that corporations generally enjoyed base period earnings substantially higher than the long-period average. The alleged percentage varies, depending on the period chosen, the scope of corporations included, and the measure of earnings adopted.

No such increased amount is either contemplated by the statute or justified by the facts.

First, concerning the intent of the statute, the objective under section 722 is the normal earnings of a taxpayer, and not normal earnings plus something. If, in the case of taxpayer belonging to a variant profits cycle industry, the concept of normal earnings is correctly interpreted as being an average of earnings over a period of one or more complete cycles, then there is no warrant for any addition to the long-term average as an element in normal earnings.

Second, as to the facts, the data in the "Statistics of Income", correctly interpreted, fail to disclose any reliable evidence that for the average corporation the rate of return during the base period differed materially from the rate of return expected under average or normal conditions for the 18 years ending in 1939. It is true that the data show the annual average of compiled net profit or loss during the base period to be 15.5 percent higher than for the 18-year period 1922-1939. But if, in order to approximate excess profits net

income, the necessary adjustment is made to eliminate tax-exempt income, the difference is reduced to 8.5 percent. If a further adjustment is made for interest paid out, to eliminate the effect of a shift away from borrowed capital and in the direction of equity capital, the data show average base period earnings some 6.6 percent *lower* than the 18-year average.

The data given in "Statistics of Income", moreover, are by no means strictly comparable over the long period covered. An obvious weakness is the fact that the data refer to a growing number of corporations. Another factor leading to an overstatement of net income in the base period, as compared with the years prior to 1934, is the change made in that year in the method of reporting income, caused by the removal of the statutory privilege of filing consolidated returns for affiliated corporations (except in the case of railroad corporations).

(D) Proof of sporadic profits experience.

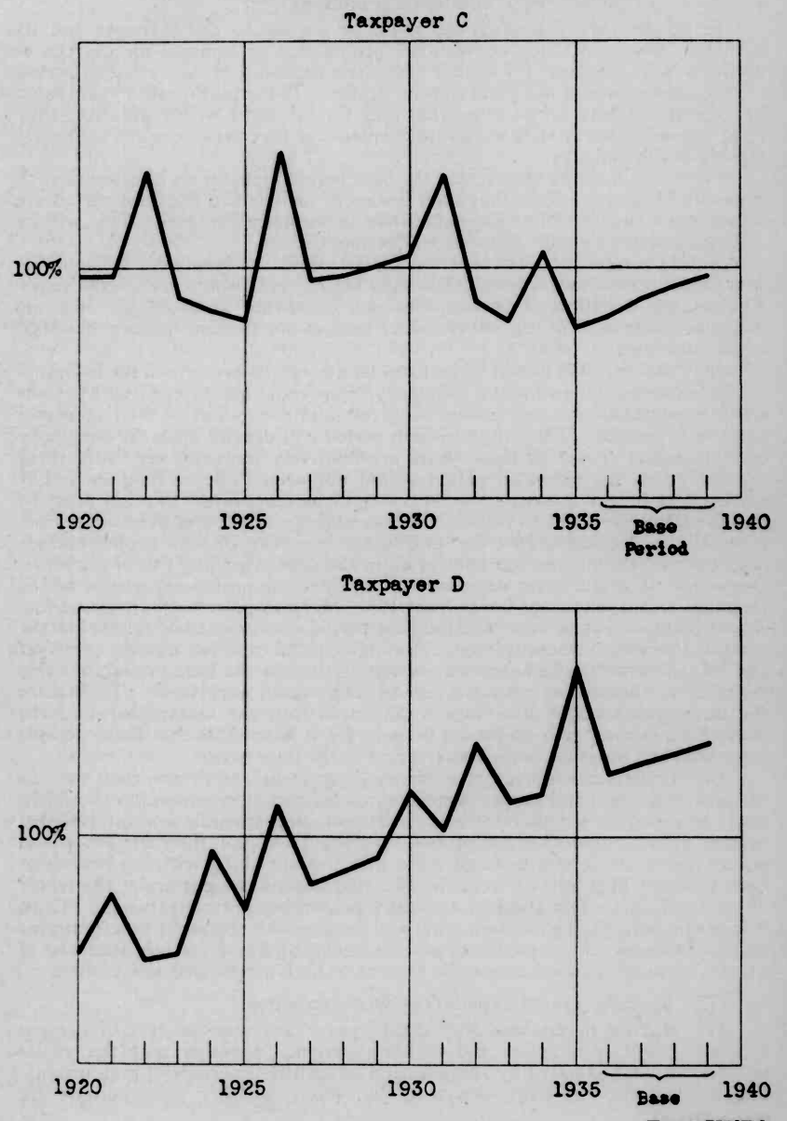
Figure 2 shows the characteristics of the profits of corporations which qualify for relief under section 722(b)(3)(B). Here the picture is one of jagged, irregular profits, with high points coming at unpredictable intervals. There may also be other influences such as a cycle or a growth trend, but the main characteristic is the occasional occurrence of years of strikingly high profits. Thus in Corporation C, aside from the high-profits years, there is evidence of some cyclical movement—a low level in the middle 20's and the middle 30's and a high level in the late 20's and early 30's. In the case of Corporation D the high-profits years are superimposed on a distinct and substantial upward trend in profits.

(1) In contrast with the regular wave-like movement of profits under section 722(b)(3)(A), as shown in Figure 1, the behavior which forms the basis for relief under section 722(b)(3)(B) is characterized by the sharp and irregular fluctuations shown in Figure 2. In this case, at random intervals there is a period of high profits accompanying high production substantially above the production and profits levels of adjacent periods.

As in the case of variant cycle taxpayers, reference should be had only to data conforming as nearly as possible to the definition of excess profits net income. Again, as discussed above in connection with variant cycle cases, care must be taken to deal with data which are representative of the taxpayer during the base period. Thus, if there have been significant changes during the period studied in the size of the taxpayer as measured by physical capacity, capital assets or net worth, a ratio of annual earnings to one of these factors might well be employed in the analysis instead of the annual earnings in dollars.

In the case of Taxpayer C, shown in Figure 2, it is apparent that the years 1922, 1926, 1931 and 1934 were years in which profits were substantially higher than the general level existing at the time. The general level, aside from these high-profits years, was not constant throughout the twenty-year period shown, but was at a fluctuating level having some relation to general business conditions; thus, the level of profits in the late 1920's was somewhat higher than in the early 1930's. This illustrates the fact that sporadic profits may be superimposed on a fluctuating level. In the case of Taxpayer D, it is apparent that the taxpayer was enjoying a steady and substantial rise in its level of earnings, in addition to having six years of sporadically high profits. In both cases it should be noted that the mere existence of the fluctuations in profits does not qualify the taxpayer for relief.

Figure 2. SPORADIC PROFITS TAXPAYERS



(2) To qualify under section 722(b)(3)(B), the profits experience of the taxpayer must meet several additional conditions:

First, the jagged fluctuations must be normal to the taxpayer and its industry; they must not be windfall profits due to unusual circumstances unlikely to be repeated, for in that case their inclusion in the extended period of comparison would not yield normal profits. These high-profits years must be exceptional only in the sense that they do not occur with regularity; they must, however, occur with moderate frequency if they are to qualify as characteristic of the industry.

Second, it must be shown that the base period includes no instance of such periods of high profits, or that such instances included in the base period are either less frequent or less favorable than is normally expected. This will be discussed in more detail below under "reconstruction."

Third, to meet the test of section 722(b)(3)(B), the profits in the sporadic years must be substantially and strikingly higher than profits in adjacent years. The mere fluctuation of profits does not constitute proof of the sporadic behavior referred to in the statute, since such minor fluctuations are universal in all industries.

(3) No extended period of uniform length can be prescribed for examination in order to determine the frequency of sporadic and intermittent periods when high production and profits occurred, and the extent of their increases over other periods. The length of such period will depend upon the frequency of high profits years. If these years are relatively frequent, say every three or four years, the extended period would not need to be as long as if they occurred at longer intervals, say every eight or ten years. Caution must be observed, however, not to restrict the investigation to an unduly short period, especially in the late 1920's, for an unusual bunching of high profits periods might occur at that time and none at all in the next preceding five or six years. In general, it would seem necessary to consider the profits experience of the taxpayer and its industry for at least 10 or 15 years prior to the base period.

It is important to note that the base period itself must be included in the extended period to be considered. The high-profits experience of the taxpayer and its industry may be inadequately represented in the base period, but this period nevertheless constitutes a part of their recent experience. To exclude the base period might introduce a distortion into the measurement of the normal expectancy of high-profits periods, for it is possible that these periods were bunched together immediately prior to the base period.

(4) If there is satisfactory evidence of sporadic and intermittent periods of high production and profits over an extended period, examination should be made to ascertain whether there are corresponding sporadic and intermittent periods of low production and profits. If these are found, their frequency and severity must be determined and taken into account along with the periods of high profits. This follows from the fact that what is sought under the whole of section 722 is a fair and just amount representing normal earnings. Thus, if sporadic periods of low production and earnings are normal to the taxpayer and its industry, they constitute just as much a part of the fair standard of normal earnings as do the sporadic periods of high production and profits.

(E) Sporadic profits experience—Reconstruction.

(1) Having determined that the taxpayer has met the test of demonstrating that its production and profits experience, together with that of its industry, is characterized by sporadic and intermittent periods of high production and profits, the next step is to determine whether such periods are

inadequately represented in the base period years, and, if so, to reconstruct the normal earnings of the taxpayer. The computation to determine the constructive average base period net income will answer both of these requirements.

Having determined the length of the extended period to be considered, as discussed above, there are at least two methods for computing the constructive average base period net income. Wherever in the following discussions reference is made to average base period net income, the term means the simple arithmetic average of the annual incomes, deficits included, rather than the statutory average base period net income as defined in section 713, which may reflect the application of the growth formula, deficit rule, or 75 percent rule.

(2) The first method, as suggested by the regulations, is to proceed exactly as in the case of a variant profits cycle case as discussed in section (C) herein. Since the essential nature of the depression of the base period net income is the same in both cases, namely, that the base period is unrepresentative of the normal experience of the taxpayer, the reconstruction can proceed along similar lines. This method will be especially useful in such cases as Taxpayer C in Figure 2, where, in addition to the sporadic high-profits years, there is evidence of some cyclical influence, and there is no distinguishable long-time upward or downward trend in profits. Just as in the case of reconstruction under section 722(b)(3)(A), if dollar amounts of annual income are employed, the average of the annual incomes (deficits included) over the extended period is used as the constructive average base period net income. If ratios, such as net income to net worth, are employed to represent earnings in each year, a fraction is formed having as its numerator the average of these ratios during the base period, and as its denominator the average of the ratios during the extended period. The average base period net income, in dollars, is then divided by this fraction to find the constructive average base period net income.

(3) In some cases, however, this method of reconstruction will be of questionable validity, either because there may be a trend upward or downward in the net income of the taxpayer or because of some extraordinary factor with a significant influence on the profits experience of the taxpayer and its industry. In the case of Taxpayer D in Figure 2, for instance, it would obviously be inequitable to reconstruct the average base period net income of the taxpayer on the basis of the average of the twenty-year period, since the growth in earnings has carried the taxpayer during the base period well above the long-term average. In other cases there may have been in the earlier period several years of high earnings due to influences which were no longer operative in the base period, so that there would be no justification for considering the average for the longer period as being the constructive average base period net income.

It must be remembered that an adjustment is to be made only for the absence or inadequate representation during the base period of years of high production and profits, and not for all of the influences that may have affected the profits of the taxpayer in the extended period. If there is a complex series of such influences, it may be found desirable to adopt another method of reconstructing average base period net income. This method may be stated briefly in three steps: (a) determine for each high-profits year in the extended period the percentage by which profits exceed the level of adjacent years; (b) average these percentages for the extended period and then for the base period alone; and (c) multiply the average base period net income by the ratio of the extended period average percentage to the base period average percentage.

Details of the steps follow:

(a) For purposes of explanation, the years during which high profits did not occur are defined as "standard" years, and in the present method these are considered as 100 percent. The first step is to determine for the extended period, including the base period, the amount by which the profits in each high-profits year exceeded the profits in the "standard" years adjacent. For this purpose the profits ratio (or the net income) for each high-profits year is divided by the average of the ratios (or net incomes) for the two or more adjacent years before and after the high-profits year. In this process each "standard" profits year is usually considered only once, in relationship either to a preceding or succeeding high-profits year, but it may be considered in two such comparisons, if necessary. If there are any years of sporadic low profits, the percentage relation of each of these to the adjacent "standard" years is likewise calculated, the result in each case being a percentage lower than 100. The average is then taken of the percentages for all years including "standard" years taken as 100. (It may be found convenient, as described below, first to get the averages separately for the high and low profits years.) The number of high and low-profits years, and the total number of years in the extended period are then noted, and the results are combined as illustrated below to determine the average percentage relationship of normal profits in the extended period to the 100 percent level of profits in the "standard" years.

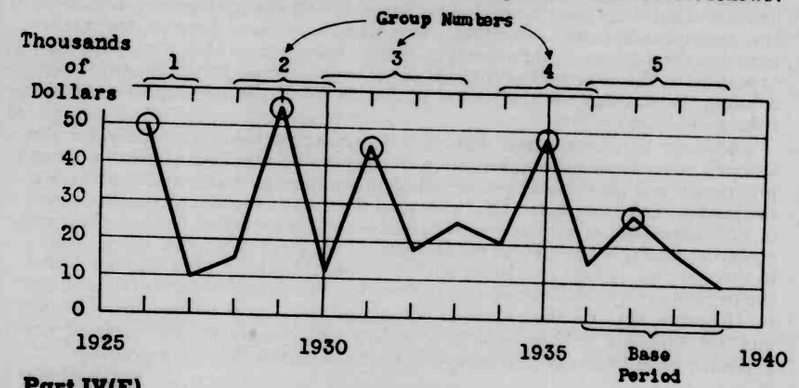
To illustrate this method, the example given in the regulations (in the fifth paragraph of section 35.722-3(c)(2)) will be worked out. The example follows:

Net Income (in Thousands of Dollars)

1926	50	1933	25
1927	10	1934	20
1928	15	1935	48
1929	55	1936	15
1930	12	1937	28
1931	45	1938	18
1932	18	1939	10

Average 17.8

As the first step in any such analysis, it is suggested that a simple chart or graph be made to aid in the identification of the high-profits years, and to determine the grouping of years for comparison. Such a chart follows:



It is obvious that the years 1926, 1929, 1931 and 1935 are years of sporadic high profits. Some question might arise concerning the year 1937, but for the present this will likewise be considered to be a year of high profits. These years are circled on the chart.

The next step is to group the years so that each high profits year may be compared with adjacent "standard" years. In two cases in the present example a given "standard" year is used twice in such a comparison, the year 1930 being in a comparison for 1929 and 1931, and the year 1936 in a comparison for 1935 and 1937. There is no logical objection to this double use of an individual year, since the only purpose is to measure the magnitude by which each high-profits year exceeds the level of adjacent years. Having decided upon the grouping of years for comparison, the computation can be conveniently made as follows:

Group No.	High-Profits Years		Adjacent "Standard" Years			Ratio of High Profits Years to Adjacent Years
	Year	Profits	Years	Profits	Average	
1.	1926	$50	1927	$10	....	500%
2.	1929	$55	1928 1930	$15 12	$13.5	407%
3.	1931	$45	1930 1932 1933	$12 18 25	$18.3	246%
4.	1935	$48	1934 1936	$20 15	$17.5	274%
5.	1937	$28	1936 1938 1939	$15 18 10	$14.3	196%
			Average for Extended Period			325%

It appears, then, that in the fourteen years covered there were five years of sporadic high profits in which, on the average, profits were 325 percent of their level in adjacent years. This leaves nine "standard" years in which profits are taken to be 100 percent. Thus for the extended period, the average percentage relationship of profits can be computed as follows:

Extended Period:

$$\frac{(5 \times 325) + (9 \times 100)}{14} = \frac{1625 + 900}{14} = \frac{2525}{14} = 180.4\%$$

This means that in the extended period, on the average, profits were 80.4 percent above the level in the "standard" or non-high-profits years.

(b) The next step is to make a similar computation for the base period. In the example there was one year in four when profits were 196 percent (group 5) of adjacent years. The computation is thus as follows:

Base Period:

$$\frac{(1 \times 196) + (3 \times 100)}{4} = \frac{496}{4} = 124\%$$

This shows that in the base period the average level of profits is 24 percent above the "standard" of the non-high-profits years. Since this excess is less than that found above for the extended period, the taxpayer is entitled to relief, and the extent is computed as follows:

(c) The adjustment to be applied to the base period net income is computed by forming the ratio:

$$\frac{\text{Extended Period Percentage Relationship}}{\text{Base Period Percentage Relationship}}$$

Thus in the example:

Adjustment:

$$\frac{180.4\%}{124\ \%} = 1.455$$

This shows that the average base period net income for the taxpayer must be multiplied by 1.455, or raised by 45.5 percent, in order to adjust for the inadequate representation in the base period of periods of high production and profits. In the example given, the average base period net income is $17,800. Thus the constructive average base period net income is computed as follows:

C.A.B.P.N.I.: $17,800 × 1.455 = $25,900

It is interesting to note that in this case the result obtained by taking the 14-year average of profits (paragraph (2) above) is approximately the same as that just obtained, namely, $26,400 compared with $25,900.

It is obvious that this method of computation is not purely mechanical or automatic, but includes an element of judgment both in the identification of certain years as high-profits years, and in the choice of adjacent years for comparison.

4. A second example will illustrate a case where, in the extended period, there were certain years of sporadically low profits. Assume that in the extended period there were four years out of eighteen with high profits, and that the average relation of profits in these years to profits in standard years was 240 percent (as found in the first step). Assume, secondly, that two years out of the eighteen were low-profits years with average profits only 75 percent of standard. It follows that the remaining twelve years were "standard", or 100 percent. The steps are as follows:

(a) The average percent relationship of the extended period would then be computed as follows:

Extended Period:

$$\frac{(4 \times 240) + (2 \times 75) + (12 \times 100)}{18} = \frac{960 + 150 + 1200}{18} = \frac{2310}{18} = 128.3\%$$

This means that in the extended period, on the average, profits were 28.3 percent above the level in the "standard" or non-high-profits years.

(b) The next step is to make a similar computation for the base period. Assume that one year out of the four was a high-profits year with profits 30 percent above adjacent years, and that there were no years of low profits. The computation would then be as follows:

Base Period:

$$\frac{(1 \times 130) + (3 \times 100)}{4} = \frac{130 + 300}{4} = \frac{430}{4} = 107.5\%$$

This shows that in the base period the average level of profits is only 7.5 percent above the standard of the non-high-profits years. Since this excess is less than that found above for the extended period, the taxpayer is entitled to relief, and the extent is computed as follows:

(c) The adjustment to be applied to the base period net income is computed by forming the ratio $\frac{128.3\%}{107.5\%} = 1.193$.

Thus, the average base period net income of the taxpayer must be multiplied by 1.193, or raised by 19.3 percent, in order to adjust for the inadequate representation of periods of high production and profits. Assuming that the average base period net income of the taxpayer had been $50,000, then the constructive average base period net income would be $50,000 × 1.193 = $59,650.

(5) As a final example, assume that for another taxpayer in six years out of fifteen profits were high and averaged 130 percent of the adjacent standard years, and that there were no years of substandard income. Suppose that in one year of the base period profits were 190 percent of standard. The computation would be as follows:

Extended Period:

$$\frac{(6 \times 130) + (9 \times 100)}{15} = \frac{780 + 900}{15} = \frac{1680}{15} = 112\%$$

Base Period:

$$\frac{(1 \times 190) + (3 \times 100)}{4} = \frac{190 + 300}{4} = \frac{490}{4} = 122.5\%$$

This shows that the base period is not an inadequate standard of normal earnings as compared with the extended period, and no relief is warranted. Even though the frequency of the occurrence of high-profits years in the base period is inadequately represented (1 year in 4 as compared with 2 years in 5 in the extended period), the extent of the increase (190 percent as compared with 130 percent in the extended period) is more than sufficient to compensate for the inadequate frequency.

Part V

COMMENCEMENT OR CHANGE IN CHARACTER OF BUSINESS

Subpart I

QUALIFYING PROVISIONS

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Law.—Section 722(b)(4).

Regulations.—Section 35.722-3(d).

(A) General rule.

In order for a taxpayer to obtain relief through the provisions of section 722(b)(4) it must be entitled to use the excess profits credit based on income and it must establish—

(1) That it commenced business or changed the character of its business either during or immediately prior to the base period; and

(2) That because of such commencement or change in character its actual average base period net income is an inadequate standard of its normal earnings for the entire base period; and

(3) The fair and just amount representing normal earnings to be used as a constructive average base period net income.

The relief afforded by sections 722(b)(1), (2), and (3) is based upon the existence of factors which adversely affect the average base period net income. In contrast, the relief afforded by section 722(b)(4) is based upon the existence of factors which produce a higher level of normal earnings than the level of earnings which existed during the base period as a whole. If the entire base period does not reflect *normal* operations based upon the new or changed circumstances, the average base period net income is deemed to be an inadequate standard of normal earnings.

A taxpayer seeking relief under sections 722(b)(1), (2) or (3) is in effect asserting that its base period is normal except for the abnormal circumstances. Presumably, such a taxpayer would have established its place in its industry by the beginning of its base period. It would already have experienced periods of normal operations in which normal earnings were realized. A taxpayer seeking relief under section 722(b)(4) may have no periods of normal earnings. It is requesting relief either because it did not reach during the base period an estab-

lished position in its industry and its level of normal operations, or because it attained such position and level during only part of the base period. In either event, the taxpayer does not have normal earnings for the entire base period based upon such normal operating conditions.

Merely because the taxpayer has commenced business or changed the character of its business immediately prior to or during the base period does not mean that it is entitled to relief under section 722(b)(4). In addition, it must establish that its average base period net income is inadequate as a standard of normal earnings because it does not reflect the normal operation of the new or changed business for the entire base period. Ordinarily, an inadequacy will exist if the period of development which follows the commencement or change falls within the base period. However, the inadequacy may have been compensated for by the use of the growth formula under section 713(f) which may have resulted in an actual average base period net income equal to the income for the last base period year. Likewise, windfall income, or income derived from war or other abnormal circumstances, may give rise to an average base period net income which is equal to or better than a constructive average base period net income which does reflect normal operations of the new or changed business for the entire base period.

To be entitled to relief under section 722(b)(4), the taxpayer must show that the commencement or change in character occurred as the result of normal conditions. Normal operations cannot result from abnormal circumstances or conditions. (See G. C. M. 24013 (C. B.-1943, 794).) Hence, it is necessary that the taxpayer present facts not only with respect to the existence of the commencement or change but also with respect to the specific circumstances or reasons causing the change or commencement.

Many claims have been filed which are based on a commencement or change in character caused by events resulting from the war. War must be considered an abnormal event. Thus, in those instances where a change in character is for the purpose of manufacturing war material, the change must be considered an event stemming directly from the war and therefore abnormal. This must be so even though the taxpayer is regularly a producer of ordnance material. It is also true regardless of the fact that the change may have normal peacetime utility.

This position, however, should not be construed to include all taxpayers which are engaged in the production of war material during the excess profits tax taxable years. If the change forming the basis of the claim was motivated by peacetime conditions it resulted from normal events and the fact that the change was later utilized in war production is not a bar to relief.

The principles expressed in G. C. M. 24013 are not to be limited in their application to the specific type of situation therein covered so as to be confined to events stemming directly from the existence of war. For example, the heavy armament programs of various nations prior to, as well as after, the actual outbreak of war in September, 1939, are considered to have produced certain abnormal conditions. Under these programs some manufacturers, particularly producers of material which is necessary in preparing for war, received unusually large orders for their products well in advance of actual hostilities. Sales by the manufacturer or selling agent of such material could not have been expected to continue under normal conditions in the volume realized during the rearmament period. This is equally true in the case of sales made by producers to other concerns supplying war orders. Accordingly, normal earnings cannot be constructed on the basis of such abnormal conditions. If a

taxpayer's contentions under section 722(b)(4) are predicated upon other circumstances which are fortuitous or transitory it is not entitled to relief for the reason that such circumstances, being of a temporary nature, cannot produce normal earnings for the purposes of section 722.

The commencement or change in the character of the business must have occurred during or immediately prior to the base period. The words "immediately prior to the base period" do not necessarily refer to a brief or specified period of time. It is the causal relationship between the commencement or change and the inadequacy of the base period earnings which is important, and not the mere length of time prior to the beginning of the base period that the event occurred. Thus, the commencement or change will generally be considered to have occurred immediately prior to the base period if the normal level of earnings attributable to the commencement or change would not be reached until after the beginning of the base period. Conversely, if the period of initial development ordinarily required by a business to perfect its internal operations and establish its position in the industry had been completed by the beginning of the base period, the commencement or change in character will not be considered to have occurred immediately prior to the base period.

If the normal level of earnings attributable to the commencement or change was reached some time prior to the base period, so that the entire actual base period net income reflected the full normal level of earnings, such commencement or change will not be considered to have occurred immediately prior to the base period for the purposes of section 722(b)(4). If such a situation would have occurred but for the fact that the earnings for the first base period year were abnormally depressed because of an unrelated event, the commencement or change will not be considered to have occurred immediately prior to the base period. In such case there is no causal relationship between the commencement or change and the inadequacy of the actual base period net income.

For example, suppose a calendar year taxpayer commenced or changed the character of its business in 1933 and under ordinary circumstances attained its normal level of earnings in 1935. However, because of a strike or fire the income for 1936 was abnormally depressed. The inadequacy of the base period income for the year 1936 is not caused by the commencement or change in 1933 and accordingly the commencement or change is not deemed to have occurred immediately prior to the base period.

The length of time which has elapsed between the commencement or change in character of the business and the attainment of a normal level of earnings resulting from such factor is not to be ignored, however. The longer this period of time, the more difficult it becomes to substantiate a causal relationship.

Under section 722(b)(4), the factor causing the inadequacy in the actual average base period net income is the commencement or change in character which results in the failure of the actual average base period net income to reflect the normal operations of the new or changed business for the *entire* base period. The determination of the fair and just amount representing normal earnings therefore requires a reconstruction of earnings for the entire base period to reflect normal operations for the new or changed business. The second sentence of section 722(b)(4) provides the following rule to be used in determining the level of normal earnings at the end of the base period attributable to the new or changed business:

> "If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer has commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time."

This provision, known as the two-year push-back rule, is designed to permit reconstruction of the entire base period by taking into account the level of earnings which would have existed at the end of the base period had the taxpayer had the advantage of two years' lengthened experience under normal conditions. Theoretically, the push-back rule must be applied to all section 722(b)(4) cases to determine whether the taxpayer is entitled to use a constructive average base period net income based on a higher level of earnings than was actually reached by the end of the base period. However, in many cases it will be apparent that the business of the taxpayer does reflect the full effect of the commencement or change by the end of the base period. In such cases, it is unnecessary to give any further consideration to the push-back rule, since the actual earning level will be taken into account in reconstruction of base period net income.

(B) Commencement of business—Scope.

The application of section 722(b)(4) is limited to taxpayers which "* * * either during or immediately prior to the base period, commenced business or changed the character of the business." The words "commenced business" do not have the same meaning as "in existence." Ordinarily, a corporation commences business when it starts the business operations for which it was organized; it comes into existence on the date of its incorporation.

In the case of *Eveready Loan Company, Petitioner v. Commissioner of Internal Revenue,* 2 T. C. 1035 [CCH Dec. 13,600], the Tax Court stated:

> "Congress, in the exercise of its sovereign power to tax, might have set forth, in most unequivocal language, the test to be applied in ascertaining when a domestic corporation was 'in existence' for the purposes of section 712(a). It would be a simple matter to have specifically made, beyond any question whatever, the actual conduction of business the test. Such requirement would have been binding and conclusive * * *."

and later:

> but it may exist even without being empowered to engage in business."
> "Hence, not only may a corporation be in existence without engaging in business,

In view of this difference in meaning between commencement of business and existence, in order to be entitled to relief under section 722(b)(4) because it commenced business during the base period, a taxpayer must demonstrate that it engaged in activities during its base period which are substantially equivalent to commencing business operations. Mere organizational activities such as incorporation or the issuance of capital stock are not sufficient. It is necessary that the activities of a corporation be advanced to the extent necessary to establish clearly the nature of its regular business operations so that construction of its base period net income can be made without recourse to its post-1939 experience. Such extent may be indicated by the acquisition of operating assets which are necessary to the type of business contemplated.

For example, a corporation may have been organized during the latter part of the base period for a specific purpose. While no sales were made until 1940, it completed its organizational activities during the base period and also acquired a business site and machinery for its plant, so that by the end of the base period the nature of the taxpayer and the character of its business as contemplated

were readily determinable. In this case the taxpayer will be considered to have commenced business during the base period.

(C) Change in character of business—Scope.

Section 35.722-3(d) of Regulations 112 provides the general test to be applied to all alleged changes in the character of a business:

> "A change in the character of the business for the purposes of section 722(b)(4) must be substantial in that the nature of the operations of the business affected by the change is regarded as being essentially different after the change from the nature of such operations prior to the change. No change which businesses in general are accustomed to make in the course of usual or routine operations shall be considered a change in the character of the business for the purposes of section 722(b)(4). Trade custom and practice may be taken into account in determining whether an essential difference in the character of the business has occurred. A change in the character of the business, to be considered substantial, must be reflected in an increased level of earnings which is directly attributable to such change. * * *"

The type of qualifying change contemplated by the statute and the regulations is one which produces a marked, basic and lasting difference in the nature of the operations of the business and which results directly in a substantially higher level of normal earnings. Accordingly, routine changes customarily made by businesses, changes temporary in character or changes which have no effect on the normal range of profits may not be considered to have produced a change in the character of the business within the intent and meaning of section 722(b)(4).

The statute defines a change in the character of the business as including changes coming within certain specified categories. It does not follow, however, that the character of a business is different solely because it comes within one of these categories. Under dynamic business conditions, all corporations make changes in the nature of their business operations and in their products. Attempts are constantly made to cut costs, to better the products or services furnished, to operate more efficiently, and to grow in size. Over a four-year period, it is conceivable that every business enterprise will present aspects that are different at the end of the period than they were at the beginning. The statute might have allowed relief to a corporation merely because its business was somewhat different at the close of its base period than at the beginning. In such event, every corporation which is liable for excess profits tax would be entitled to relief, and to have earnings predicated upon the basis of its business as it existed as of the close of its base period. The statute does not so provide. What the statute does provide is that the tax shall be considered to be excessive and discriminatory if the taxpayer's average base period net income is an inadequate standard of normal earnings because it made one of the changes *in character* described in the statute. To the extent that the changes are ordinary, usual and routine, they are normal and are not a departure from the character of the taxpayer's business which produces an inadequate standard of normal earnings. Such changes do not form the basis for relief, even though it is shown that higher earnings resulted. The change must be sufficiently extensive to cause an essential difference in the nature of the business operations.

Ordinary technological improvements developed in the regular course of business, changes in supervisory personnel which have little or no effect upon basic business policies, or mere improvements in products or services, are types of changes which do not result in a change in the character of the business and are, therefore, not recognized.

The change must likewise be substantial in that as a direct result of the change the level of normal earnings of the business was increased materially over what such level would have been had the change not been made.

Increased earnings for any period after a change has been made may be attributable wholly or partially to factors other than the change. Shifting economic circumstances and seasonal variations affect the course of most businesses whether or not internal changes are made, and cause fluctuations in earnings from one period to another. Consequently, in many cases it will be necessary to determine the factors which caused an increase in earnings. When monthly or quarterly statistics of earnings before and after a change are being considered the following general tests might be applied.

(1) If the business is not affected by seasonal variations, percentages of increases or decreases in monthly sales might be compared with simultaneous fluctuations in the economic circumstances of the class of customers of the business. For example, the sales of a retail business will depend upon the purchasing power of its customers. An index of the income, wage and salary payments in its trade area may furnish a basis for determination of the extent to which increases in sales are due to improved economic conditions.

(2) If the business is affected by seasonal variations, comparison might be made with the monthly percentages of increases or decreases in sales of a business selling the same type of products and affected by the same economic conditions and seasonal variations and which has not changed its character during the base period.

(3) Comparison of increases or decreases in the percentages of the elements of gross profit and net profit to sales with the same percentages for a comparative business may indicate the extent to which increases in earnings due to reduced costs and expenses were attributable to factors other than the change.

(4) An increase in earnings claimed to have resulted from a change may have had the result of eliminating or reducing earnings from some other activity of the business. Consequently, it is necessary to consider earnings from all affected portions of the business. Assume that a difference in the products or services furnished has occurred as the result of the discontinuance of a product or service previously furnished and the addition of a different line of products or services. The new product or service may produce earnings less than the old products or services would have produced. Ordinarily the taxpayer would not be entitled to relief under these circumstances. It would not be prohibited, however, as stated in the regulations, from showing that an increased level of earnings would have been attained during the base period but was hindered or delayed by unusual or peculiar events or economic circumstances.

(5) In contrast to the cases where there has been a complete substitution of one activity of a business for another activity, such as described in the preceding paragraph, there will be cases where a partial cessation of an existing activity will occur. For example, the opening of a new theatre in a city where the taxpayer operated several other theatres may cause a higher level of earnings due to the addition of the new theatre. Comparison of the operation of the older theatres before and after the opening of the new theatre may show a substantial decline in admissions and earnings for the older theatres. The increased level of earnings to be attributed to the change must take into account the adverse effect on earnings of the older theatres.

(6) The mere fact that earnings for a period after the change are greater, equal to, or less than earnings for a period prior to the change is not conclusive as to whether or not there were increased earnings directly attributable to the change. In a given case earnings may be less for a period after a change than they were for a prior period. This may be due to economic circumstances over which the management of a business has no control. In such a case the earnings for the period after the change may be greater than such earnings would have been had the change not been made. For example, assume that the year 1938 was a good year and the year 1939 was a poor year for the type of business under consideration. Earnings for 1939 may be less than for 1938 even though a new and profitable product was introduced in 1939. The increased level of earnings created by the introduction of the new product may have been offset by the decline in earnings due to the less favorable economic conditions in 1939. The same tests suggested for the detection of increased earnings due to factors other than the change might be employed to determine the extent to which earnings were affected by unfavorable economic circumstances.

The statute enumerates the following kinds of changes in character:

(1) A change in the operation or management of the business.

(2) A difference in the products or services furnished.

(3) A difference in the capacity for production or operation including any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of a course of action to which a taxpayer was committed prior to January 1, 1940.

(4) A difference in the ratio of nonborrowed capital to total capital.

(5) The acquisition before January 1, 1940, of all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished, including any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated.

A taxpayer which does not come within one of these five enumerated changes is not necessarily precluded from qualifying for relief under section 722(b)(4) solely for such reason. Under the statute a change in the character of the business *includes* these specific changes; accordingly, there may be others. However, the types of changes specified in the statute are sufficiently broad to encompass most qualifying changes and any alleged change, other than those indicated, must be subjected to rigid scrutiny and a strict application of the principles, conditions and limitations of section 722(b)(4).

(1) *A change in the operation or management of the business.*

To be entitled to relief bacause of a change in the operation or management of the business, a taxpayer must demonstrate that the change is substantial as measured by two basic tests:

(i) The nature of the operations must be essentially different after the change from the nature of the operations prior to the change; and

(ii) There must be a higher level of earnings which is directly attributable to the change.

A change in operation

The regulations provide that "The introduction of new or substantially different processes of manufacturing or of new or substantially different methods of distribution would constitute a change in the operation of a business; * * *." Included in processes of manufacturing would be formulae as well as methods of fabrication and sequence of manufacture. A general rearrangement of machinery, such as a change from ordinary to assembly line methods of manufacturing, resulting in a substantial cost saving, would be a change in the operation of a business. A change in sales distribution methods from sales through retailers to sales through agents, jobbers, brokers, door-to-door, mail order or factory branches would also constitute a change in operations.

Excluded from qualifying changes would be ordinary routine improvements in fabricating techniques since such changes are normally experienced by manufacturing businesses generally.

A mere change in the cost of purchased raw material is not sufficient to constitute a change in the character of the business and can therefore not qualify under section 722(b)(4). However, where the change in cost is of such magnitude, and is due to factors of such a nature as to constitute a change in the method of operation, there may be a qualifying change in character.

For example, a taxpayer used raw material which was produced a considerable distance from its plant. The taxpayer's cost of raw material therefore included a substantial freight charge. During the year 1939 a permanent source of the same raw material was discovered only a short distance from the taxpayer's plant. Its costs were therefore substantially reduced. Such change in cost is sufficient to constitute a change in the operation of the business. Likewise, if the taxpayer had operated its own transportation system from its source of raw material, and then abandoned the system upon the discovery of a nearby source, such an abandonment would constitute a change in the operation of the business, under section 722(b)(4).

Caution should be observed in connection with the foregoing illustration. Most changes in cost which business is able to make do not result from factors which can qualify for relief under section 722(b)(4). In order to qualify, the change must be radical in the sense that it is not routine but effects an essential difference in the nature of the operations and the character of the business. It also must be so substantial and permanent in nature that the business has attained, as a result, a new higher level of normal earnings.

A new and higher level of normal earnings will not necessarily result from a decrease in costs such as is assumed above or from an increase in volume which may result from such cost reduction. A new level of earnings will result only if the decrease in cost may clearly be presumed to continue and is not offset by a reduction in selling price. In some cases a reduction in costs such as is described above may be temporarily restricted to the taxpayer, but later shared by its competitors. In such a case the taxpayer has simply enjoyed a windfall which swells its earnings but does not put it on a new level of normal earning power.

If a taxpayer can satisfy all the tests suggested above, and particularly if it can establish that it has attained an enduring level of increased earnings, it is the position of the Bureau that it may be entitled to relief under section 722(b)(4) despite the fact that the changes did not result directly from acts of the taxpayer.

A new or different operation which was not in existence on December 31, 1939, but which is said to have been feasible because of an increased capacity

for production or operation present on December 31, 1939, is not to be considered unless it is compelled by, or inherent in, the fact of the increased capacity. In such case the new operation would be said to be an integral part of the increased capacity and thus be considered in that respect. If, for example, the taxpayer had been manufacturing a product by machining an essential part, but had constructed a new plant and had acquired new machinery for casting such part prior to December 31, 1939, casting shall be considered the normal operation with respect to such part even though the new plant and machinery were not placed in operation until 1940. If, however, the new plant and machinery were designed to continue the machining process, but if after December 31, 1939, the taxpayer changed to the cheaper and more efficient method of casting, normal earnings must be based upon machining of the part and not casting.

A change in management

In order to qualify as having a change in management, it is necessary for a taxpayer to show a change in key managing personnel or a change in basic management policies by existing management. There is no precise definition of key personnel. The controlling consideration is not the number of positions changed but rather the relation of such changes to the basic management policies of the business. A qualifying change would probably result from a change in a corporation's directorate that entailed a broad reorganization of management policies. The emphasis should be placed on a change in the policies of the business rather than on the change in personnel. Such policy changes must be definite, basic and identifiable; not vague, general or routine.

There is no presumption that a change in management will result in increased earnings. The taxpayer must clearly show that the increased earning resulted from the change. A change in management which was effected during a period of business expansion, such as the year 1939, may not be related to an increase in earnings. General conditions may have been such that the increased earnings would have resulted even if there had been no management change.

The regulations envision a qualifying change in management as one resulting in "drastic changes from old policies." Such a change will usually be reflected in a demonstrable change in business operations. Generally, a taxpayer alleging a change in management should be able to demonstrate the validity of its contentions by showing some change or changes in its business operations which resulted from the change in management.

If relief is claimed because of a change in management, it may be recognized only with respect to those policies adopted and actually put into effect by December 31, 1939.

(2) *A difference in the products or services furnished.*

In order for a taxpayer to be entitled to relief because of a difference in the products or services furnished, it must show that such change is substantial as measured by two basic tests:

(i) The nature of the operations must be essentially different after the change from the nature of the operations prior to the change; and

(ii) There must be a higher level of earnings which is directly attributable to the change.

A difference in the products or services furnished may occur through either the addition of a new product or service or the elimination of a product

or service previously furnished. Such addition or elimination, however, must represent more than a usual or customary event in the type of business in which the taxpayer is engaged. In certain types of business it is customary to eliminate unprofitable lines and add new lines as, for example, a business the products of which are affected by style changes. Such variations in products would not qualify as differences in products furnished.

Moreover, a product or service must be substantially different from the products or services previously furnished; mere improvement does not constitute a difference. The addition or elimination of a new product to or from a line of varied products, as where a novelty store selling hundreds of items adds several new lines, will not ordinarily be held to constitute a difference in the products furnished.

Relief is afforded under this provision of section 722(b)(4) if there is "a difference in the products or services furnished". It is necessary, however, to differentiate between changes in products produced with existing capacity and the changes in product based on new capacity acquired actually or constructively prior to January 1, 1940. The reasons for this differentiation will be developed below.

If a new product is manufactured with existing capacity in substitution for another product, relief is necessary because the new product results in a higher normal earning level than the product which is replaced. In such a case relief may be based on the new product within the limits of the plant capacity which actually existed prior to January 1, 1940. Subject to this limitation, if earnings did not reach by the end of the base period the level which they would have reached had the shift been made to the new product two years earlier, the change shall be deemed to have been made at such earlier time and normal earnings shall be computed on this basis. In other words, with the proper showing of the total market for the new product and proof of the ability of the taxpayer to compete in that market (see Reconstruction Under Section 722 (b)(4)), the taxpayer may be able to reconstruct base period earnings on the assumption that all or any part of its plant capacity, including unused capacity, was devoted to the production of the new product.

If, however, the difference in products furnished in the base period resulted from the construction or acquisition of new facilities designed to produce a new product to be sold in addition to the product previously sold, relief should ordinarily be predicated on the basis of an increase in capacity. This is desirable for several reasons: First, it is immaterial whether the additional units of product furnished are units of a new or of an old product, or whether the new product shows a higher or lower margin of profit than the old. The essential nature of the case is that the taxpayer's *capacity* to produce has been increased. Second, the new capacity may have been committed for in the base period but not operated or only partially operated prior to January 1, 1940, so that the taxpayer may find it necessary to rely upon the commitment rule which does not extend to a difference in product furnished.

The new product may represent a substitution for an old product but may require some new capacity for the purpose of producing the new product. In such case it will not be necessary to separate the several components representing the change in the character of the business or to subdivide the computation of normal earnings into several parts. Only one computation will be necessary based upon the new product and upon the capacity actually or constructively existing by December 31, 1939.

Under no circumstances shall reconstruction be predicated upon capacity not in existence actually or constructively by December 31, 1939. Additional productive facilities which *might* have been acquired or constructed prior to January 1, 1940, if the new product had been introduced two years earlier cannot be allowed as a basis for constructive sales of a new product, since this would nullify the limitation on the increased capacity rule set out in section 722(b)(4). Likewise, capacity acquired after December 31, 1939, cannot be used as the basis of reconstructed sales of a new product unless such capacity is admitted under the commitment rule.

In determining whether there is a difference in the products or services furnished, consideration should be given to the following factors:

(a) *Class of products or services furnished.*

If the new product or service is similar to the regular line of products or services previously furnished, it is doubtful if the taxpayer can establish that a "difference" exists. For example, a brewery which previously manufactured only light beer adds the production of dark beer and ale; or, an ice cream manufacturer adds new flavors; or, a bakery expands its line of bread and cake. In these instances the fundamental class of products furnished has remained unchanged and the nature of the operations is not essentially different after the addition of the new products from the nature of the operations prior to the addition.

(b) *Markets.*

A difference in the products or services furnished may be indicated if the consumer market for the new product is different than the old. For example, the market for the new product might be manufacturing establishments and other business concerns, while the market for the old product might be the retail store trade.

(c) *Manufacturing operations.*

A difference in the products furnished may be indicated if the manufacturing processes necessary to produce the new product are essentially different. For example, production of the new product may require technically skilled labor and machinery of types never before utilized.

(d) *Resemblance to existing products or services.*

If the end product is essentially the same in nature and use, the product may not be different, but merely a modification of an existing product. To illustrate, a linoleum manufacturer using cork and burlap as raw materials changed to wood fibre and cotton fabric. The finished product had the same character and use as before. The substitution of the new raw materials resulted in a modification of an existing product rather than a new product.

(e) *Consumer opinion.*

A difference in the products furnished may be indicated if the consumer considers the product to be new even though it may be similar in appearance to other products. If, in the opinion of the consumer, the product is regarded as being new because it has new uses, reacts differently or is purchased from a new source, it may constitute a different product.

(f) *Trade opinion.*

The regulations provide that "a product or service is different from another product or service if the trade custom or practice treats it as a product or

service of a different class." If the taxpayer can meet the test set forth in this specific language, the alleged new product or service must be deemed to constitute a difference in the products or services furnished.

(3) *A difference in capacity for production or operation including commitments.*

A taxpayer may be entitled to relief through the provisions of section 722 (b)(4) if it establishes a difference in its capacity for production or operation. Also included is any change in the capacity for production or operation of the business consummated after December 31, 1939 as a result of a course of action to which the taxpayer was committed prior to January 1, 1940.

In order for a taxpayer to be entitled to relief because of a difference in the capacity for production or operation, it must demonstrate that the change meets two basic tests:

(i) The change must be substantial, of a permanent or lasting nature, and not of a routine character; and

(ii) There must be a higher level of earnings which is directly attributable to the change.

Section 722(b)(4) provides that the business must have commenced or changed its character either during or immediately prior to the base period. An exception to this rule applies to change in capacity cases where the taxpayer was committed to the change prior to January 1, 1940, even though such change was not actually consummated until after December 31, 1939. If the taxpayer can establish by competent evidence that it was committed, prior to January 1, 1940, to a course of action leading to such change, the change is deemed to have occurred December 31, 1939. A discussion of what constitutes a commitment is given in subsequent paragraphs.

A change in the character of a business through a change in operation or management, previously discussed, affords relief to those corporations which substantially improve their businesses by the introduction of new processes of manufacture, or through the stimulation of new management in such business (House of Representatives Report No. 2333, C. B. 1942-2, page 479); while a difference in the capacity for production or operation is concerned with increases in physical plant or scope of operations. A further and more important distinction lies in the fact that the commitment rule is applicable only to cases involving a difference in the capacity for production or operation.

To illustrate, assume that in the year 1939 a calendar year taxpayer decided to make substantial changes in key managing personnel for the purpose of improving its business through a change in its manufacturing and sales distribution methods and that this change was not consummated until 1940. This taxpayer would not be entitled to relief because the change in character did not occur during or immediately prior to the base period. On the other hand, if this taxpayer had committed itself during 1939 to improve its business by enlarging its manufacturing facilities so as to permit substantially increased production, and had actually taken steps during 1939 to effect this change, such as planning and contracting for the construction of the increase in capacity, it would be entitled to relief through the application of the commitment rule, even though the actual increase in capacity was not effected until 1940.

Capacity for production is the ability of a given plant or its several departments to perform, under conditions usual and normal for the plant, the productive processes required in the manufacture of the product or products

of the plant. It may be expressed in terms of the number of units which can be made or in terms of the essential productive processes in which the plant engages.

The capacity of a plant may be affected by the output of a department which is the limiting factor or "bottleneck" of the entire plant. For example, a plant manufactures a product requiring five successive processes which are performed in separate departments. If one department constitutes a bottleneck, then an increase in the capacity of this department will increase the capacity of the entire plant. Conversely, any increase in other departments without the removal of the bottleneck will not increase the capacity of the plant as a whole. Thus, a textile manufacturer may install new looms which substantially increase its capacity to weave cloth. If its business is to produce and sell cloth in a finished and dyed state, an increase in weaving capacity will not increase the capacity of the business unless there is also an increase in finishing and dyeing capacity or unless unused capacity for these operations already exists.

It should be noted at this point that published industrial directories which list individual plant capacities will, in most cases, not reflect true capacity for purposes of section 722. These "rated capacity" data are often based on the maximum capacity of the basic machinery of the plants, and they generally do not reflect differences in plant organization and other factors which may impose significant limitations on output or operations.

The capacity of a plant must be distinguished from its *output,* which depends, among other things, on the hours per week it operates. A change from one shift to two shifts per day does not constitute an increase in capacity, but represents the utilization of formerly idle capacity.

One of the many difficult problems arising in capacity cases is the determination of an accurate unit of measurement for determining the extent of the difference in capacity. Most businesses have a standard unit of measurement such as foot, barrel, ton, or gross. In these cases the customary unit of measurement for the particular kind of business will be used. In other businesses having no standard unit of measurement for the finished product, an acceptable alternative might be to express capacity in terms of the principal raw material utilized. Dollar amounts will be used only as a last resort and then only if it can be established that no distortion results.

The words "capacity for production or operation" as used in the statute should be construed as alternatives, i. e., capacity for production or capacity for operation. They are intended to afford corporations of varying types of business activity the right to relief because of a change in character resulting from a difference in the physical capacity to do business. Some corporations are engaged in the business of manufacturing products for sale. In such instances an increase in the capacity for production results from an increase in the manufacturing facilities. For example, a taxpayer makes a product requiring one manufacturing process. The plant consists of ten machines, all of which are used in the manufacture of the product. The taxpayer purchases five additional machines, resulting in an increase in the quantity of the product produced. The acquisition of the new machines represents an increase in the taxpayer's capacity for production. In another instance, a taxpayer makes a product requiring several manufacturing processes, the final process being painting. Previously, this process was performed by outside contractors, but in 1939 the taxpayer built its own paint plant, after which it performed the painting process itself. There was no increase in the number of the finished

units manufactured as a result of the acquisition of the new facilities. Nevertheless, the taxpayer has increased its productive capacity to the extent that it now performs a new essential manufacturing process. Consequently, this taxpayer is considered to have a difference in its capacity for production within the meaning of section 722(b)(4). (See G. C. M. 24329 (I. R. B. No. 16 (1944) page 13).)

Other corporations are engaged in business activities which are not related to the production of goods but involve selling operations or the rendering of services. In these instances an increase in the capacity for operation results from an increase in capacity to make sales or render services. For example, an automobile dealer operates under a franchise from the manufacturer which permits it to sell automobiles in a specified territory. The franchise is revised and as a result the dealer's territory is greatly enlarged. The extension of the dealer's franchise would ordinarily represent an increase in its capacity for operation.

A change in the character of the business which becomes operative through the use of facilities is limited by the capacity of the facilities existing or committed for by December 31, 1939. A change in character does not carry with it the productive capacity necessary to effectuate the change. For example, a taxpayer on a calendar year basis establishes that it changed the character of its business in 1938 by the addition of a new product to its line of manufactured goods. Its annual output of the new product at the end of the base period amounted to 1,000,000 units. The taxpayer also establishes, by applying the push-back rule, that had it made the change in 1936 it would have sold 6,000,000 units of the new product in 1939. However, the taxpayer's facilities to make the product had a capacity of only 1,500,000 units per year at the end of the base period and it was committed to the acquisition of additional facilities having a capacity of 2,500,000 units. In this case reconstruction is limited to an amount based on 4,000,000 units per year, notwithstanding the fact that it conclusively showed it could have sold 6,000,000 units in 1939.

Section 722(b)(4) provides the circumstances under which an increase in the capacity for production during or immediately prior to the base period may form the basis for relief. Provision is also made for recognizing certain increases in capacity after the base period through the application of the commitment rule. To assume, in the above illustration, that the ability to sell 6,000,000 units carries with it facilities to produce 6,000,000 units, when the facilities owned or committed for would produce only 4,000,000 units, would nullify the conditions and limitations of section 722(b)(4) with respect to increases in the capacity for production under the commitment rule.

Differences in the capacity for production or operation include:

(a) The acquisition of new facilities.

(b) The enlargement of existing facilities.

(c) The utilization of latent productive or operative capacity and the development of new techniques with respect to existing facilities which expand the productive or operating capacity of such facilities.

(d) An increase in liquid working capital permitting of an enlarged scope of operation.

(a) *The acquisition of new facilities.*

The new facilities must represent a substantial addition to the capacity for production or operation. Determination of the changed capacity will usually

require an analysis of the fixed asset accounts. The taxpayer must show that the alleged new facilities are not in fact ordinary replacements. A replacement of an old machine with a new one is not an increase in capacity unless it can be shown that the new machine has a greater capacity than the old, and constitutes an addition to the capacity of the plant as a whole.

(b) *The enlargement of existing facilities.*

Business in general is continually enlarging existing facilities as a result of natural growth. Any increase of existing facilities must be substantial to constitute a change in the character of the business, and such increase must make a substantial addition to the productive capacity of the plant. Thus, the addition of a warehouse to a plant is not necessarily a change in character of the business. Such an addition probably would have little or no effect on the productive capacity of the plant and would hardly result in an increased level of earnings.

(c) *Utilization of latent capacity.*

A difference in the capacity for production or operation also exists where capacity, latent in existing productive or operative equipment, is brought out by radical technological developments. A distinction is necessary between the words "latent" and "idle." The utilization of idle capacity does not constitute a change which is recognized under section 722(b)(4). The word "latent" means not visible or apparent; hidden; dormant. The word "idle" means not occupied or employed.

The utilization of latent capacity in productive or operative equipment usually requires some development work or the application of special fixtures to the existing equipment to bring out the additional capacity which existed but was incapable of being used. For instance, the development of high speed cutting tools which would permit a faster operation of machines would probably result in the utilization of latent productive capacity.

Thus, a qualifying change in the character of the business requires a change in existing productive operating equipment or processes which make available to the taxpayer for the first time a substantial increase in the productive capacity.

On the other hand, idle capacity is capacity which is available under existing conditions but is not utilized, such as the capacity which is present in "stand-by" equipment or in the part-time operation of a plant. The change from an eight to a twenty-four hour work day or from a five to a seven-day work week represents the utilization of idle capacity. Surplus capacity which existed solely by reason of lack of demand for the products is not latent capacity.

The utilization of idle capacity may be illustrated by a company which owned two plants, only one of which was being operated. During 1939 the idle plant is put in operation. No increase in capacity resulted. Likewise, an electric power plant has auxiliary or relief generating equipment to take care of peak demand periods. A more intensive use of such stand-by equipment does not constitute a change in capacity.

In cases where it is difficult to distinguish between idle and latent capacity, a proper test may be whether the taxpayer has made a capital expenditure in the development of latent capacity. Ordinarily, no such expenditure is required in the utilization of idle capacity. This test is not conclusive but may be a reliable guide in making the distinction.

(d) *Increase in liquid working capital.*

The regulations provide that a difference in the capacity for production or operation also exists where liquid working capital has been increased admitting of an enlarged scope of operations.

The term "liquid working capital" as used in the regulations means the excess of current assets over current liabilities.

A taxpayer's volume of business may be controlled or limited by the amount of its available working capital. To the extent that such working capital is increased eliminating the restriction on the capacity for production or operation, the taxpayer's capacity for doing business may be increased.

The amount of a taxpayer's working capital varies from day to day. Such fluctuations are normal and should not be made the basis for relief. Likewise, gradual increases in working capital resulting from accumulation of profits during periods of general improvement in business are ordinary and usual and do not result in a change in the character of the business.

To qualify as a difference in capacity the increase in working capital must be substantial in amount and unusual in the sense that it stems directly from a transaction designed to effect such increase. For example, a corporation's business operations are limited by insufficient working capital to finance current activities. Production is considerably less than normal capacity and inadequate to fill orders on hand. Capital stock issued and outstanding is increased from $1,000,000 to $1,500,000 by the sale of additional stock for cash. Such a taxpayer would be deemed to have effected a difference in the capacity for production or operation by reason of an increase in liquid working capital. Likewise, a closely held corporation which operated on a restricted basis because of inadequate working capital, and which remedied this condition by obtaining from its stockholders cash contributions to its capital as paid-in surplus or as long-term loans, would have effected an increase in liquid working capital. It is necessary, as a prerequisite for relief, that in such cases the increase in working capital results directly in an increase in the taxpayer's level of earnings.

Borrowings in the nature of short-term loans do not result in an increase in liquid working capital. Such loans, while they supply the necessary cash to finance seasonal, current, or temporarily expanded operations, are both routine and temporary and, therefore, do not constitute a change in the character of the business. Transactions of this nature have no effect on working capital for the reason that the increase in current assets is offset by a corresponding increase in current liabilities.

The commitment rule, as discussed below, may be applicable to a change in capacity resulting from an increase in working capital if the taxpayer can establish the existence of a valid commitment. If, for example, a taxpayer had entered into a contract with the underwriters of capital stock which was to be issued for the purpose of raising working capital, such contract may constitute a commitment for a change in capacity.

Commitment cases

A commitment case is one which is defined in the statute as:

> "Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939 as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, * * *."

In such cases the change in the character of the business is deemed by the statute to have been made on December 31, 1939.

This rule provides relief in those cases where the change in capacity was not consummated prior to January 1, 1940. It is only applicable to changes in the character of the business arising from a difference in the capacity for production or operation.

To be entitled to relief as the result of a commitment, a taxpayer must establish that it was committed prior to January 1, 1940, to a course of action leading to such change. This requirement is in addition to the necessity of meeting the two basic tests regarding the substantial nature of the change. A legally binding form of commitment is not required, but in the words of the regulations it should be proved by "* * * any * * * change in position unequivocally establishing the intent to make the change and commitment to a course of action leading to such change. * * *"

A qualifying commitment should meet all of the following tests:

(1) *Change of position.*

The taxpayer should establish that it has made a substantial change of position toward effecting the change in capacity, such as the expenditure of substantial sums of money in the commencement of the desired change; the institution of legal proceedings looking toward the change; or the consummation of a contract for the construction, purchase or other acquisition of facilities resulting in the change.

(2) *Establishment of intent.*

The change in position must unequivocally establish the intent to make the change within a reasonably definite period of time. Its significance should not be open to doubt. Thus, the mere purchase of land is not, standing alone, a change of position which points exclusively to the acquisition of new facilities, or pledges the taxpayer to any specific use of the land.

(3) *No withdrawal without substantial detriment.*

The commitment should be of such nature that it will not permit the taxpayer to withdraw without substantial destriment. Negotiation prior to a contract for the purchase of facilities, or payment of a nominal fee for a construction permit would not be sufficient.

A resolution of the governing body of a taxpayer may establish a commitment if it contains in itself the necessary elements which comprise the change in position and clearly and with certainty indicates the course of action to which it purports to commit the taxpayer. Thus, the action of a board of directors may be the acceptance of an offer which binds the taxpayer to the making of a change in capacity. Ordinarily, however, a resolution of a board of directors will be found to be an internal act of the corporation which does not itself change the position of the taxpayer but which requires additional action pursuant to it to constitute the commitment.

A commitment is not necessarily invalidated because it was later modified. However, if the change in capacity actually consummated is less than the additional capacity committed for, only the actual capacity acquired may be considered as the change occurring on December 31, 1939. For example, a taxpayer was committed prior to January 1, 1940, to the purchase of ten machines as evidenced by a contract and a cash deposit. In 1940 the contract was modified so that the number of machines actually acquired was reduced to eight. In this instance the commitment would be recognized for eight machines.

On the other hand, if the change in capacity actually constructed is *more* than the additional capacity committed for, only the capacity committed for may be considered as a change occurring on December 31, 1939. For example, assume in the above illustration that, although the contract called for ten machines, the taxpayer actually acquired twelve machines. Even though the additional machines may have been acquired from the same seller and at the same time, a commitment would be recognized for only the ten machines contracted for prior to January 1, 1940.

Since the statute deems that the change in character was made December 31, 1939, for the purpose of reconstruction under the push-back rule, the change in character in commitment cases will always be considered to have been made December 31, 1937.

Under the commitment rule the changed capacity actually entering into the business during the first excess profits tax taxable year (and possibly later excess profits tax taxable years) will usually be less than the extent to which the change was deemed to have entered into the business under the application of the two-year push-back rule. Therefore, the variable credit rule, as discussed in Part V, subpart II (F), will ordinarily apply to commitment cases.

In all cases of facilities acquired under a commitment, it should be shown whether they formed the basis of an application for a certificate of necessity as defense facilities. The issuance of such a certificate would be a strong indication that the acquisition was a direct consequence of the defense program and would require the application of the principles enunciated in G. C. M. 24013 (C. B. 1943, 794). The taxpayer may overcome this position only by affirmative evidence to the contrary indicating clearly that the facilities would have been acquired or built in the normal course of business.

(4) *A difference in the ratio of nonborrowed capital to total capital.*

A taxpayer's average base period net income does not represent a fair basis for comparison with earnings during the excess profits tax taxable years if, without a decrease in total capital, the nature of the total capital has changed in whole or in part from interest-bearing borrowed capital to a type of capital which does not give rise to an interest deduction. In such case, the interest deductions in the base period years are not offset by comparable interest deductions in the taxable years, notwithstanding the fact that the total capital has not been decreased.

In recognition of this situation, section 722(b)(4) provides that a change in the character of the business includes "a difference in the ratio of nonborrowed capital to total capital." The term "nonborrowed capital" means equity invested capital as defined in section 718, and the term "total capital" means equity invested capital as defined in section 718 plus borrowed capital as defined in section 719(a). Section 715 defines invested capital and sections 716 to 719, inclusive, define the component parts thereof. Section 715 states that the definition is "for the purposes of this subchapter * * *.", and such definition is therefore applicable to section 722. Consequently, for the purposes of this computation, borrowed capital will not include outstanding indebtedness which is not evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust. Likewise, total capital will not be reduced by a deficit in earnings and profits which, under section 718, is considered as zero. In computing average equity invested capital for a base period year, the accumulated earnings and profits only at the beginning of the year are taken into account.

The reconstruction of base period income to reflect this change in character is accomplished by the elimination of deductions made in the base period years for interest paid or accrued on borrowed capital which has been retired by December 31, 1939, limited, however, to the amount of the interest on such part of the retired borrowed capital as is offset by an increase in equity invested capital.

This provision of section 722(b)(4) may be illustrated by the case of a calendar year taxpayer which, at the end of its base period, December 31, 1939, had a total capital of $3,000,000 composed of $2,000,000 equity invested capital and $1,000,000 borrowed capital. Assume further that the nature of this taxpayer's capital changes during the base period are as follows:

Year	Average Borrowed Capital	Average Equity Invested Capital	Total Capital	Interest Deduction (5%)
1936	$2,500,000	$ 800,000	$3,300,000	$125,000
1937	1,500,000	1,300,000	2,800,000	75,000
1938	1,200,000	2,400,000	3,600,000	60,000
1939	1,100,000	1,800,000	2,900,000	55,000

Such taxpayer would be entitled to increase its actual base period net income in the amount of $60,000 for 1936, $25,000 for 1937 and $5,000 for 1939, computed as follows:

Item		Base Period Years 1936	1937	1938	1939
(1)	Average borrowed capital	$2,500,000	$1,500,000	$1,200,000	$1,100,000
(2)	Borrowed capital as of December 31, 1939	1,000,000	1,000,000	1,000,000	1,000,000
(3)	Decrease in borrowed capital	$1,500,000	$ 500,000	$ 200,000	$ 100,000
(4)	Average equity invested capital	$ 800,000	$1,300,000	$2,400,000	$1,800,000
(5)	Equity invested capital as of December 31, 1939	2,000,000	2,000,000	2,000,000	2,000,000
(6)	Increase (or decrease) in equity invested capital	$1,200,000	$ 700,000	$ (400,000)	$ 200,000
(7)	Recognized decrease in borrowed capital (item 3 or item 6, whichever is the lesser)	$1,200,000	$ 500,000	None	$ 100,000
(8)	Interest deduction adjustment (5% of item 7)	$ 60,000	$ 25,000	None	$ 5,000

In the above illustration, attention is directed to the year 1938. Although there has been a decrease in borrowed capital between that year and the end of the base period, equity invested capital and total capital have also decreased during the same period. The decrease in borrowed capital has not been offset by a corresponding increase in equity invested capital. There is therefore no change in character because of a difference in the ratio of nonborrowed capital to total capital at the end of the base period as compared with the year 1938.

Ordinarily, relief under this provision will result from an increase in base period net income because of the elimination of interest deductions on borrowed capital which was paid off by December 31, 1939. However, there may have been base period years in which the deduction for interest was low as compared with interest deduction at December 31, 1939, because of a change from equity

capital to borrowed capital. To illustrate, assume that in the preceding example the capital changes during the base period were as follows:

Year	Average Borrowed Capital	Average Equity Invested Capital	Total Capital	Interest Deduction (5%)
1936	$2,500,000	$ 800,000	$3,300,000	$125,000
1937	500,000	1,800,000	2,300,000	25,000
1938	700,000	2,400,000	3,100,000	35,000
1939	800,000	2,100,000	2,900,000	40,000

In this case the taxpayer would be entitled to increase its actual base period net income in the amount of $60,000 for 1936 and must decrease its actual base period net income in the amount of $15,000 for 1938 and $5,000 for 1939, computed as follows:

Item		Base Period Years 1936	1937	1938	1939
(1)	Average borrowed capital	$2,500,000	$ 500,000	$ 700,000	$ 800,000
(2)	Borrowed capital as of December 31, 1939	1,000,000	1,000,000	1,000,000	1,000,000
(3)	Decrease (or increase) in borrowed capital	$1,500,000	$ (500,000)	$ (300,000)	$ (200,000)
(4)	Average equity invested capital	$ 800,000	$1,800,000	$2,400,000	$2,100,000
(5)	Equity invested capital as of December 31, 1939	2,000,000	2,000,000	2,000,000	2,000,000
(6)	Increase (or decrease) in equity invested capital	$1,200,000	$ 200,000	$ (400,000)	$ (100,000)
(7)	Recognized decrease (or increase) in borrowed capital (item 3 or item 6, whichever is the lesser)	$1,200,000	None	$ (300,000)	$ (100,000)
(8)	Interest deduction adjustment (5% of item 7)	$ 60,000	None	$ (15,000)	$ (5,000)

Comparing the capital structure during the years 1938 and 1939 with the capital structure as of the end of the base period, there has been a change from equity capital to borrowed capital, and the deduction for interest in those years is therefore abnormally low. Comparing the year 1937 with the end of the base period, there has been an increase in borrowed capital, but since there was no corresponding decrease in equity invested capital, there has been no change in character.

The relief allowed by section 722 is limited to " * * * a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period, * * *." A constructive average base period net income does not represent normal earnings if it has been reduced by abnormally high interest deductions; the comparison with earnings during the excess profits tax period is distorted.

As in all cases where relief is claimed because of a change in the character of the business, to be entitled to relief because of a difference in the ratio of nonborrowed capital to total capital, a taxpayer must demonstrate that the change is substantial as measured by two basic tests:

(i) The nature of the operations must be essentially different after the change from the nature of the operations prior to the change; and

(ii) There must be a higher level of earnings which is directly attributable to the change.

The mere fact that this particular factor under section 722 is capable of exact mathematical determination does not, of itself, make it mandatory to adjust the actual base period net income regardless of the amount of the adjustment. In other words, not every case in which the base period interest deductions are greater than the interest deductions during the taxable year is entitled to relief. It is necessary that the character of the business be changed. For example, a taxpayer reduced its average borrowed capital from $100,000 to $90,000, resulting in a decrease in its annual interest charge from $5,000 to $4,500. The taxpayer is not considered to have changed the character of its business by reason of this nominal change. To constitute a change in the character of the business, an annual interest deduction which is substantial in relation to the net income must be substantially reduced as a result of the change in the nature of the capital employed.

The type of case for which relief is contemplated by the statute is one in which a large part of the capital employed in the business is represented by borrowed capital, and this borrowed capital has been retired by the application of funds derived either from the accumulation of earnings and profits or from the sale of capital stock. In such case the recapitalization amounts to a basic and permanent change in the capital structure of the business, so that the character of the business is actually changed.

On the other hand, if a taxpayer which ordinarily finances seasonal operations or periods of slow collections through short-term borrowings happens to effect a nominal reduction in such borrowings, it has not changed the character of its business by such action.

In the case of a fiscal year taxpayer, the principles relating to fiscal year taxpayers generally, as discussed in Part VIII, should be applied. The computations should be based on a comparison of borrowed capital and equity invested capital at December 31, 1939 with the respective amounts of such capital during the portion of the base period prior to January 1, 1940. Changes in borrowed capital and equity invested capital occurring after December 31, 1939, must be disregarded in computing the amount of the adjustment.

(5) *Certain acquisitions of assets of competitors.*

A taxpayer may be entitled to relief through the provisions of section 722(b)(4) if it acquired before January 1, 1940, all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished. Also included in this provision is any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated.

In order for a taxpayer to be entitled to relief under these conditions, it must show that the change is substantial as measured by two basic tests:

(i) The nature of the operations must be essentially different after the change from the nature of the operations prior to the change; and

(ii) There must be a higher level of earnings which is directly attributable to the change.

Except as noted below, the statute provides the conditions under which the acquisition of the assets of a competitor may form the basis for relief:

(i) The acquisition must occur prior to January 1, 1940.

(ii) All or part of the assets of the competitor must be acquired.

(iii) The acquisition must result in the elimination or diminution of the competition.

The regulations provide that the form of the acquisition or the taxable nature of the transaction are immaterial for the purpose of section 722.

Careful consideration should be given to the requirement that competition must be eliminated or diminished; that the parties are in fact competitors. Competition is the rivalry of two or more independent business concerns seeking the patronage of the same customers. Generally two subsidiaries of the same parent corporation are not considered to be competitors, nor are a parent and its subsidiary nor two commonly-owned corporations. Management policies are controlled by the same persons in these cases, and the essence of competition is absent.

An examination should be made of the nature of the alleged competitors' businesses, including type of products and location and type of markets. Thus, two building construction contractors are not competitors if one is a factory building contractor and the other specializes in the construction of dwellings. The consolidation or merger of such businesses would result in an expansion of the business operations of the resulting corporation rather than a decrease in competition. Likewise, the producers of similar products may not be competitors. For example, two building contractors might both specialize in dwelling construction. One, however, confines its activities to the development of low price housing communities, while the other is the builder of individually planned homes on a cost-plus basis. While both are contractors for the construction of dwellings, they can hardly be called competitors.

With respect to taxpayers engaged in the dissemination of information through the public press, the statute recognizes, as a factor causing a change in the character of the business, the acquisition of the assets of a competitor before May 31, 1941. If this type of acquisition occurred prior to January 1, 1940, the requirements previously set forth with respect to other acquisitions prior to January 1, 1940 must be met. If the acquisition by the taxpayer engaged in the dissemination of information through the public press occurred after December 31, 1939, but before May 31, 1941, the statutory requirements differ from the requirements relating to acquisitions prior to January 1, 1940, in the following respects:

(i) Substantially all the assets of the competitor employed in the competition must have been acquired; not merely a part.

(ii) The acquisition must have resulted in the elimination of competition; not merely in its diminution.

The statute provides that the competition which is eliminated must have existed prior to January 1, 1940; accordingly, the acquisition of the assets of a competitor which came into existence after December 31, 1939, would not qualify under this provision for the reason that no competition existed prior to that date.

The application of the push-back rule in the reconstruction of average base period net income where the acquisition occurred between December 31, 1939, and May 31, 1941, will be similar to its application in commitment cases. The reconstruction will always be made as though the change occurred on December 31, 1937, since the acquisition is deemed by the statute to have occurred on December 31, 1939.

Part V

COMMENCEMENT OR CHANGE IN CHARACTER OF BUSINESS

Subpart II

RECONSTRUCTION

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(A) Introduction.

(1) *Comparison with section 722(b)(1), (2), and (3).*

Attention has previously been directed to the contrast of section 722(b)(4) with subsections (b)(1), (2), and (3). In section 722(b)(1), (2), and (3) cases, the primary object is to remove the effect of the abnormal circumstance and to restore normal earnings based on normal operations already achieved and known. In the section 722(b)(4) case, the essential problem is to determine what constitutes normal operations for the taxpayer so that a normal earning level can be predicated thereon and normal earnings computed. Accordingly, under section 722(b)(1) or (2) the taxpayer will probably be able to point, for purposes of comparison, to periods of normal earnings within its base period or, in the case of section 722(b)(3), beyond the base period. In the case of a section 722(b)(4) claimant this situation may not exist since the business as commenced or changed in character may never have reached its normal level of earnings by the end of the base period. This fact, together with the specific provisions of section 722(b)(4) not found in the other subsections, creates special and difficult problems of reconstruction.

(2) *Normal earnings under section 722(b)(4).*

The problems of reconstruction under section 722(b)(4) cannot be avoided by recourse to the general provision of section 722(a) that the constructive average base period net income shall be the fair and just amount representing normal earnings. Standing alone, this provision might seem to offer the greatest possible latitude in the construction of normal earnings. It has been urged that the taxpayer as it existed during the excess profits tax taxable year should be examined, and then normal earnings which would have been made in such year should be determined. These earnings would then serve as the constructive average base period net income under section 722(a). This position cannot be accepted. Section 722 contains explicit principles governing the computation of normal earnings in section 722(b)(4) cases. These principles may not be broadened. They must be followed in every case if substantial justice is to be done to the taxpayer and to the Government and if the concept of normal earnings is to have a consistent meaning.

The pertinent provisions of section 722(b)(4) relating to the construction of normal earnings are as follows:

> "The taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business. If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time."

The average base period net income must therefore be constructed so that it *does reflect the normal operation for the entire base period of the business commenced or changed in character.* Normal operations must be related to base period conditions (actual or assumed) and to the business commenced or changed in character. If the taxpayer did not attain normal operations by the close of its base period, so that its normal earning level was not reached, it is limited in determining such normal earning level, to what its normal operations would have been by assuming that it had commenced business or changed the character of its business two years prior to the actual event.

The problem of determining a fair and just amount representing normal earnings under section 722(b)(4) may be divided into two major parts:

(a) The determination of what constitutes normal operating conditions for the taxpayer, and

(b) The method of constructing income to reflect the normal operating conditions thus determined.

The first part is concerned with the determination of the normal operating conditions which are to be reflected in earnings. The second part is concerned with the methods and techniques of reconstruction whereby these conditions are translated into amounts of income.

(B) Theory of reconstruction of normal earnings.

(1) *In general.*

Before an analysis may be made of what constitutes normal operating conditions, certain basic principles in the light of which normal operating conditions are to be determined must be discussed.

(a) *Reconstruction for the entire base period.*

The computation of normal earnings must be based upon normal operations of the business for the *entire base period.* Contrary arguments have been presented based upon that portion of section 722(b)(4) which provides:

> "If the business of the taxpayer did not reach, by the end of the base period, the earning level it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time."

The contention is that in such cases the only method of computing the amount of relief is to assume that the taxpayer had a two-year extended experience. Upon the basis of the earnings to be computed for each of the base period years of assumed existence and an amount equal to 8 percent of the invested capital for any base period year in which it was not in assumed existence (section 713(d)(2)), a constructive average base period net income would then be computed either under section 713(e) or 713(f).

Thus, under this contention if a corporation commenced business on January 1, 1939 and had not reached its level of normal earnings by December 31, 1939, the end of its base period, it would be deemed to have commenced business on

January 1, 1937. The constructive average base period net income would be computed on the basis of an amount determined for 1936 upon invested capital and for the balance of its base period upon the earnings which the corporation would have earned under the push-back rule. This conclusion is not valid for several reasons.

First, under section 722(b)(4), relief is necessary because the average base period net income does not reflect the normal operation for the entire base period of the business. Any amount of relief to be computed must therefore be based upon the normal operation for the entire base period. Although it may be "normal" for a newly commenced business to have an operating deficit or low earnings in the first years of operation, such a condition may not represent "normal earnings" or "normal operation" for the corporation as it is presumed to exist at the end of the base period with two years' earlier experience. Moreover, in the example given no normal operating conditions were postulated for 1936.

Second, the contention misapprehends the purpose of the push-back rule, which is to provide for the computation of the normal earning level at the end of the base period rather than for the complete reconstruction of the entire base period.

Third, the method contended for would result in a computation of normal earnings in the case of the taxpayer which had not reached its normal earning level by the close of its base period which is radically different from the computation in the case of a taxpayer which had reached its normal earning level by that time.

(b) *Reconstruction must be limited to the qualifying changes.*

It has previously been mentioned that all business enterprise was somewhat different at the close of 1939 than at the beginning of the base period. Likewise, since the earnings of every corporation fluctuate in amount from year to year, and since 1939 was a year of good business conditions, it is not unlikely that the earnings of the last year in the base period of many corporations were the best of any year in such period. Congress did not afford relief for these reasons. It specifically limited relief to those cases in which the *character of the business* had changed, and thus excluded from relief inconsequential or routine changes and situations involving solely an increase in earnings in 1939 over prior base period years. It also negatived the right to relief under section 722(b)(4) based solely upon the fact that the corporation earned more money at the close of 1939 than it did during the base period.

Relief under section 722(b)(4) is necessitated by an inadequacy in average base period net income caused either by (1) the commencement of the business prior to January 1, 1940, or (2) the change in the character of the business actually occurring, or constructively occurring under the last sentence of section 722(b)(4), by December 31, 1939. The determination of normal earnings, therefore, cannot be based upon circumstances, events, or factors which are not statutory reasons for relief and which, of themselves, do not entitle the taxpayer to relief.

Consequences which are alleged to qualify the taxpayer for relief and which might be said to follow from the actual events qualifying the taxpayer but which have not actually occurred by December 31, 1939, cannot be considered in determining the character of the taxpayer with respect to which the reconstruction will be made.

It has been argued that under the two-year push-back rule the taxpayer is authorized to reconstruct earnings based upon all circumstances which would

normally have obtained if the taxpayer had made the qualifying changes two years earlier. The fact that additional changes have been made within two years after December 31, 1939 has been adduced to prove that such additional changes would have been made by that date if the qualifying change had been made two years earlier.

These arguments cannot be accepted. The purpose of the push-back rule is not to enable the taxpayer to prove what further qualifying changes might have flowed from the actual qualifying changes, and then to permit the reconstruction of income based upon all such changes. The rule is not designed to develop reasons entitling the taxpayer to relief. The reasons for relief and the change in the character of the business, upon which relief is predicated, must all have been established prior to the use of the push-back rule. To hold otherwise would be to ignore section 722(b) which requires that any change entitling the taxpayer to relief must have actually or constructively occurred prior to the end of its base period. Constructive occurrence is limited to situations involving commitments to change capacity for production or operation and acquisitions of a competitor's assets under the last sentence of section 722(b)(4).

In the latter case, the requirement that substantially all the competitor's assets be acquired delimits the extent of the acquisition and thus facilitates the ascertainment of the facts to be deemed to exist on December 31, 1939. In the commitment case the problem is more difficult but the limitations are clearly defined. The last sentence of section 722(a) permits regard to be given to post-1939 events or conditions only to the extent necessary to determine the change in the taxpayer's character. As the regulations (section 35.722-3(d), Regulations 112) provide, the post-1939 facts are thus limited to those facts which are necessary to determine the nature of the change in capacity and the extent to which the change has been reflected in the taxpayer's business. In recognizing these facts, however, as facts constructively existing on December 31, 1939, two points must be borne in mind. The change referred to is the change to which the taxpayer was committed; increases in capacity which did not result from the commitment are therefore excluded. Furthermore, in order for the actual operation of the change capacity to be the constructive operation on December 31, 1939, it must represent the normal operation for the changed capacity within the framework of base period conditions. Use of such capacity arising from post-1939 conditions which would not represent normal base period conditions cannot be deemed to exist at December 31, 1939, since base period earnings predicated upon such unusual operating conditions could not be normal.

In summary, no qualifying factor not in existence, actually or constructively, on December 31, 1939, can be considered in determining constructive average base period net income, regardless of the argument which might be made that it is a normal consequence of the actual change in character entitling the taxpayer to relief. Innovations, additions, new processes, new products, new facilities, or any factor which had not actually or constructively occurred by December 31, 1939, cannot be brought into the picture in determining what constitute "the business" for the purpose of ascertaining normal earnings attributable to such business.

(c) *Normal operating conditions must be determined with respect to the base period only.*

The theory of the excess profits credit based on income is that average income for a normal period shall be considered the standard of normal earnings by which excess profits are to be measured. The base period was con-

sidered, generally, to be a normal period. The committee reports on section 722, as amended by the Revenue Act of 1942, state "* * * it is believed that the period from 1936 through 1939 was a period of moderate prosperity for business in general."

Normal earnings and normal operations do not exist in a vacuum. They must be related to a particular taxable year or years. It is axiomatic that the income credit method of determining excess profits measures those profits against a standard of past normal earnings rather than future normal earnings. Thus, in determining normal operating conditions, only conditions (actual or constructive) existing by December 31, 1939, and income consequences of such conditions occurring by that date, may be regarded. No weight can be given to contentions that the post-war consequences of such conditions should be taken into account. Such post-war consequences may represent normal operating conditions for the post-war period. They do not represent normal operating conditions prior to January 1, 1940.

Actual average base period net income computed under section 713 is related to the statutory base period. There is nothing in section 722 which changes this concept of the base period. Furthermore, when faced with the necessity of determining a normal earning level which had not been reached by the close of the base period, section 722 (b)(4) provides for a two-year lengthened experience within the framework of the base period rather than for an extension into the excess profits period. It therefore follows that normal operations and normal earnings for any taxpayer seeking relief under section 722 (b)(4) must be constructed in the light of general business conditions such as existed within the period from 1936 to 1939. This does not necessarily mean that particular industry conditions existing during the same period must also be used. The problems involved in determining particular industry conditions will next be discussed.

(2) *Determination of normal operating conditions.*

The situation which qualifies the taxpayer for relief under section 722 (b)(4) is either a commencement or a change in character. This means that in the reconstruction of normal earnings for the taxpayer as changed a high degree of reliance must be placed upon inferences drawn from pertinent observable data. The bases for such inferences will vary depending upon the nature of the new or changed business and the particular facts in each case. Thus, if a taxpayer increased its productive capacity early in the base period, its subsequent experience prior to January 1, 1940 might furnish all the evidence necessary to establish normal earnings for the enlarged business. On the other hand, if the taxpayer changed over its plant toward the end of the base period, but prior to 1940, to produce an entirely different product, it might be necessary to draw inferences from the experience of corporations producing similar products and to reconstruct the taxpayer's earnings in the light of such experience, taking into account differences in the taxpayer's plant and operating conditions. Finally, in the difficult and unusual case of a taxpayer which began business just before 1940 to manufacture a product never before marketed, it will be necessary to determine constructively the demand for the product in the light of base period general market conditions, to determine the competitive position of the taxpayer, and to determine at what costs and at what selling prices the product would normally be produced and sold. This is a formidable task and might in a given case require that inferences be drawn

from such diverse sources as national or regional indexes of retail trade, data on trends or fashions of consumption, and adjusted costs and selling prices of related manufactured products.

The business which has commenced or changed its character in the base period has a certain form and certain tangible and intangible assets which roughly determine its nature and anticipated profits. Obviously, these characteristics of the taxpayer must be known before normal earnings can be computed. The basic or general nature of the new or changed taxpayer is, however, only the starting point in such a computation. Equally significant are the normal operating conditions, both internal and external, under which the taxpayer is considered to have operated during the period for which earnings are to be constructed. An essential prerequisite to the determination of normal earnings is, therefore, the determination of normal operating conditions.

The determination of normal operating conditions for a given taxpayer is a difficult and complex matter. This is true, first, because of the interrelationship among the various operating conditions affecting the taxpayer, second, because such conditions must be inferred rather than observed directly, and, third, because operating conditions normally shift or change materially even within such a short period as four years. It is therefore difficult to formulate general rules which will set forth a definite procedure for determining normal operating conditions. In the following discussion, however, the basic principles which underlie the determination of such conditions will be developed.

For convenience, operating conditions will be classified as follows:

(a) Internal operating conditions.
(b) General market conditions and demand for products or services.
(c) The taxpayer's competitive position.

(a) *Internal operating conditions.*

The internal operating conditions of a taxpayer are those which are inherent in its nature or which flow from its operational policies and practices. They include the size of the business, the technique of production or method of operation, the type and quality of the product or service furnished, and the methods of marketing and distribution. Other important internal operating conditions are the nature and efficiency of plant or machinery, the location of the plant with respect to markets and sources of supply, and the managerial policies of the taxpayer. Certain of these conditions are inherent in the taxpayer regardless of its stage of development; certain others grow out of, and vary with, its relative maturity and experience. All such conditions are reflected in the taxpayer's costs.

Regarded from a different point of view, there are two general aspects of the taxpayer's internal operating conditions. The first is the costs at which the taxpayer can produce its products or services. The second is the stage of development of the taxpayer's operations; this development stage may be independent of, or dependant upon and caused by, the development of a new product or service. Costs of the taxpayer will bear directly upon its competitive ability with respect to other members of its industry. Stated differently, they will have a direct bearing upon the price at which the taxpayer can sell, and therefore upon the share of the existing demand which the taxpayer may be able to supply. In any instance in which the development of the taxpayer is based upon the introduction and exploitation of a new

product or service, such development may stimulate or expand the demand for the product or service. In this latter type of situation, the taxpayer's own costs, as described above, will be a factor in the determination of the portion of the demand thus stimulated or expanded which it will be able to supply. In no event, however, may the taxpayer's efficiency or course of development concurrent with the development of the new product or service be considered to create or modify the general market conditions under which the product or service is sold.

It is obvious that the internal operations of a given taxpayer may in certain respects be identical with those of other concerns or those generally prevailing in the taxpayer's industry. Thus, a taxpayer's plant might have been located within the same freight rate territory as those of its competitors so that both its "in" and "out" freight costs were identical per unit of production or sales as compared with other concerns. In certain industries raw material buying practices might be so standardized that average market prices would fairly represent the cost of such raw materials to any taxpayer in the industry. Finally, in certain industries the basic machinery used might be furnished on lease by the machinery manufacturer, so that there would be no variation as among members of the industry with respect to the size or basic productivity of individual machines.

Where such uniformity of internal operating conditions exists, operating conditions, such as those listed above, of similar taxpayers may be substituted without adjustment. However, it will be seldom that all significant operating conditions will be identical as between any two corporations. Furthermore, it will never be safe to assume without verification that any one operating condition will be identical as between two or more corporations. Consequently, emphasis must be placed here upon differences between internal operating conditions rather than upon similarities.

It is necessary at the outset to differentiate between those internal operating conditions which are inherent in the taxpayer and those which vary with changes in general market conditions or in the taxpayer's relative competitive position. Such a differentiation is especially important in the application of the push-back rule, since inherent disadvantages cannot be overcome by experience. Furthermore, the variance or non-variance of certain internal operating conditions will often have an important bearing upon the decisions of management which in turn may influence the taxpayer's competitive position.

For example, assume that a manufacturer begins business at a location which requires an all-rail haul of its finished product to the principal consuming markets, and assume further that the bulk of the industry has the benefit of a lower water-rail freight rate without the offset of higher in-freight charges. Such a manufacturer is at a permanent disadvantage which may influence its other operations in a variety of ways. First, it may operate at a permanently lower level of earnings than its competitors. Second, it may attempt to secure higher than average market prices on the basis of quality production. Third, it may confine its sales operations to a small geographical segment of the market in which its freight disadvantage is slight. Finally, it may find it possible to economize in other costs or expenses such as wages or salaries. In every case it will be necessary in reconstruction to determine the possibilities of such offsetting factors. If none is found, reconstruction must take place within the framework of the taxpayer's disadvantageous situation. Furthermore, as has been stated, such disadvantage cannot be overcome by the application of the push-back rule.

Another illustration of inherent disadvantage in internal operating conditions might be found in the case of a taxpayer beginning business but with old and relatively inefficient machinery or plant. Various consequences might flow from this fact. Its maintenance expense might be very high but this disadvantage might partially be offset by lower interest and depreciation charges. More important, such a taxpayer might be at a disadvantage in the quality of production and might even be precluded by limitations of its plant from the manufacture of certain types of goods normally produced by its competitors. The profits of such a plant might, because of the relative inflexibility of its machines, be particularly vulnerable in an industry characterized by constant shifts in the type of finished goods produced. Still another illustration of inherent disadvantage in internal operating conditions would be furnished by a taxpayer the operations of which were affected by law, charter, or contract limitations.

On the other hand, a taxpayer might enjoy an advantage in internal operating conditions which was inherent in its plant or location. Thus, a taxpayer might begin business with a new process which, while available to its competitors, would not be adopted by them because of the heavy abandonment loss which would be involved in the scrapping of older but serviceable machinery representing a large investment. Here again, various consequences might flow from such a situation. The taxpayer might, for example, content itself with a relatively small portion of the total industry output and would thus not translate its cost advantage into price reductions. On the contrary, it might utilize its cost savings to secure volume by underselling its competitors. The course it would take and, consequently, the course reconstruction must take must be inferred from the initial management policies undertaken by the taxpayer, from the nature of the industry, and from standard competitive practices of the taxpayer's competitors. Although this is a difficult problem, it involves exactly the kind of analysis which would ordinarily be made before a decision to enter into business would be reached. In a section 722(b)(4) determination, moreover, there will always be available more information than is available to a beginning management, since the taxpayer will always have begun business and often will have had considerable base period experience.

In the type of case discussed just above the same general principles which were discussed in connection with a taxpayer with disadvantageous internal operating conditions must be observed. Thus, it may well happen that what appear to be net advantages will be offset by corresponding disadvantages. Furthermore, in no case will it be proper to adjust for a cost advantage growing out of favorable internal operating conditions without taking into account the effect of such advantages upon the other operating conditions of the taxpayer, particularly upon its competitive position.

Thus far the discussion has been concerned only with differences in internal operating conditions which are inherent in the taxpayer. Certain other internal operating conditions, while characteristic of a taxpayer at a given time or at given rates of operation, might be expected to change radically with experience or with a changing volume of sales or production. Thus, at the end of a taxpayer's base period it might be operating at high overhead costs per unit because of low volume which in turn is attributable to the taxpayer not having attained its normal competitive position. Such operating condition, i. e., high unit overhead, is not normal for the taxpayer and must be adjusted to the constructive normal volume determined for the taxpayer.

The example just set out raises again the question of the relationship between internal operating conditions and the taxpayer's competitive position. As costs go down, the taxpayer's ability to compete is increased, and as the taxpayer's competitive position improves its overhead unit cost tends to decline. In reconstruction this would seem to pose the difficult question of whether to begin with normal costs and proceed to volume, or to reconstruct costs in the light of normal volume. The answer to this problem must be found in the policy of the taxpayer and in all of the circumstances of its market and its competition. Either cost or volume may be used as a starting point in income reconstruction. As reconstruction proceeds it may be necessary to modify such initial assumptions of cost or volume as were made for the purpose of providing a starting point. From then on, successive adjustments of volume and costs must be made in order to bring into balance these two related factors. In the final result, cost and volume must be consistent in the sense that it can fairly be said that the taxpayer, operating under known competitive conditions, could have sold the finally determined volume under conditions of the finally determined cost. Somewhat more detailed consideration will be given to this process in the discussion of the application of the push-back rule.

The example just discussed was based on unit overhead costs which vary with volume. Other internal operating conditions, resulting in operating rather than overhead costs, may vary with the experience of the new or changed taxpayer. A new or changed plant will not often operate with normal efficiency from the start. During the initial operating period machines may not be perfectly adjusted and a considerable shakedown experience may be necessary before all adjustments can be made and before the various departments or processes are coordinated and integrated into an efficient whole. Furthermore, there may be a considerable wastage in early operations due to the lack of skill and experience on the part of management and labor. The quantity of substandard products may for this reason be abnormally high, reworking may be excessive, and returns or rejects may greatly increase the unit cost of saleable finished goods. To the extent that the taxpayer has shown an ability to overcome such handicaps, or to the extent that they may be demonstrated to be normal for a beginning business and abnormal for a mature one, adjustment may be made for such initial internal operating conditions, but only within the limits of the push-back rule.

Certain operating conditions which did not and could not exist throughout the base period may be assumed to exist during such period if these conditions were the basis of the taxpayer's change or commencement of business and if they constitute normal and essential operating conditions. Thus, for example, suppose a dam was built in January 1939 making a river navigable. Immediately thereafter a corporation was formed to furnish a ferry service across the river. Service began in June of 1939 and continued thereafter. The navigability of the river, made possible by the dam, must be considered one of the normal operating conditions of the corporation. As such, it must be assumed to have been in existence throughout the entire base period.

(b) *General market conditions and demand for products or services.*

The term "market", as used herein, includes all conditions and forces that influence and determine prices and volume of sales. For the purposes of section 722 these conditions and forces are those which actually existed prior to January 1, 1940. The demand for the products or services of a taxpayer

must be determined in the light of, and be reconcilable with, such base period market conditions. As used herein, the term "demand" is equivalent to the economic concept of demand, that is, quantities which could be sold at various prices. It does not mean merely the quantity which was sold, for with a given demand for the product or service, and under the same general market conditions, a greater quantity might have been sold if the price had been lower. For some products and services a given change in price would bring about only a slight increase in quantities sold, while in the case of other products and services the same reduction in price would bring about a relatively large increase in quantities sold. These are called, respectively, cases of inelastic and elastic demand.

The necessity for this concept of demand is shown by the fact that, with the change in its character, the taxpayer may change the price at which it is willing and able to sell its product or service. For instance, a change in method of operation involving decreases in costs of production may be expected under competitive conditions to result in a reduced price and an expanded volume of sales. The demand may remain the same and yet greater quantities be sold at a reduced price.

As a preliminary step in determining normal operating conditions, it may be necessary to analyze the market conditions under which the taxpayer's products or services are sold. The significant characteristics of the market, for present purposes, are (a) quantities sold, (b) prices received, and (c) the willingness of consumers to purchase additional quantities at various prices and under various conditions. In analyzing the taxpayer's market, only market conditions and forces existing by December 31, 1939, can be considered, and the two-year push-back rule cannot be utilized to modify such conditions or forces. However, in a proper case the two-year push-back rule may be used to determine, in the light of the actual market conditions, the constructive demand which would have existed for the product or service if the taxpayer and the product or service which were both in the development stage had had the benefit of two more years of base period experience.

Thus, for example, assume that a manufacturer developed and produced in 1939 a new and radically improved coal stove which was more efficient, ran for a longer period of time with one firing, burned a cheaper grade of coal, and was less expensive than existing coal stoves. By December 31, 1939, the taxpayer, because of plant development difficulties, produced and sold a number of stoves far less than the orders which it had received. Likewise, because of insufficient time in which to acquaint the consumers with the merits and advantages of the stove, demand which could be said to be normal had not yet been activated. Although the push-back rule cannot be used to modify the general market conditions under which the stove must be sold, the push-back rule can be utilized in order to establish the demand for this particular coal stove which would have existed had it been introduced two years earlier.

On the other hand, assume that a corporation began the manufacture of a new light and safe small airplane in 1939. The general market conditions surrounding the use of small planes must be determined in the light of actual base period conditions such as the need for such transportation and the facilities for the use of such planes, such as airports, traffic control systems, auxiliary landing fields, and repair and service installations. These general conditions cannot be modified by use of the push-back rule. The rule may be used, however, to establish the volume of sales which the taxpayer would normally

have realized had it introduced the plane two years earlier, regard being had for the possible increase in the demand that might have followed from the earlier introduction of the new plane under actual base period market conditions.

It must be emphasized, however, that in any case in which a constructive demand for the products or services of the taxpayer is established under the push-back rule, such demand must be consistent with general business and market conditions existing prior to and during the base period, but prior to January 1, 1940. The market conditions during 1939, which was a year of relatively good business conditions, could not be taken as the market conditions for 1938, when business conditions were relatively poor. A constructed demand must fluctuate in line with these actual base period market conditions. Likewise, in determining constructive demand, abnormal events unduly influencing market conditions existing by December 31, 1939 must be eliminated. Thus, in constructing a normal demand, abnormal market conditions existing in 1939 as a result of the European war must be adjusted by eliminating the effects of such event.

The fact that the taxpayer commenced business or changed the character of its business during or immediately prior to the base period means that it believed that market conditions were such that there was a demand for its products or services which it could supply at a profit. In many cases it will be found that these conditions actually existed throughout the base period. The taxpayer would be entitled to relief then, not because demand existed during only a part of the base period, but because it had not completed its initial development period prior to the base period and had one or more years of development losses or low profits in its base period. This problem is to be discussed under "Taxpayer's competitive position." The problem involved here is whether, in the light of actual market conditions existing throughout the base period, the demand for the taxpayer's product or service which was created during a part of the base period may be considered to exist throughout the entire base period.

Stated otherwise, the problem is whether normal demand for the entire base period is to be constructed on the basis of demand conditions existing by the end of 1939, or whether demand, actually existing in such base period years, must be used. The answer must depend upon the nature of the product, the industry of which the taxpayer is a member, and the market supplied.

Normal market and demand conditions may be classified into five categories as set forth below:

(i) If the taxpayer is a member of an established industry which has experienced relatively stable demand conditions, actual conditions throughout the base period shall be used. The fact that the demand for the products or services of the industry was greater during 1939 than at any prior time does not mean that this determines the level for the whole base period. Illustrations of this type of case might be found in the meat packing industry or in the cotton textile industry. Both represent well established industries with relatively stable demand conditions which do, however, fluctuate with general business conditions. The year 1939 represented conditions materially better than for the base period as a whole. A taxpayer commencing business or changing the character of its business within such industries must establish normal operating conditions based upon the actual demand existing during the base period years.

(ii) If the taxpayer is a member of an established industry which has passed its initial development period by the beginning of the base period but

which is growing normally during the base period, actual demand conditions existing throughout the base period shall be used. The fact that normal growth produces demand conditions which are more favorable at the close of the base period than at any other time is immaterial. The radio industry might be an example of this type of case. By the start of the base period, that industry had completed its initial development stage. Constant developments made during the base period increased the demand for the products of the industry, but could not be considered to have changed the character of the industry or to have, in effect, given it a second development period. Rather, the developments and the expanding demand are to be considered as the normal experience of industries after their development stage. If a corporation started business in the radio industry, the determination of normal operating conditions would be made by reference to the actual demand conditions existing throughout the base period. Demand conditions existing as of December 31, 1939, would not be assumed to have existed in any prior base period year.

(iii) Situations requiring the same treatment of normal demand conditions described in (i) and (ii) above might exist even if the taxpayer was a member of a new industry. This would occur if the taxpayer's product represented a new or better method of satisfying an existing demand previously supplied by a different or inferior product, and if such demand fluctuated with general business conditions or showed normal growth. The introduction of the product did not materially increase the demand for the type of material or equipment represented by the new product.

To illustrate, assume that mechanical refrigerators for home use were not developed to a commercially marketable point until 1935 (actually that point was reached earlier). Their development was not caused by any new need. The demand for refrigeration was formerly supplied by ice. Assume that the introduction of the mechanical refrigerators did not create any substantial increase in the demand for refrigeration, but that users of ice refrigeration changed over to mechanical refrigeration. In determining normal operating conditions of a taxpayer starting to manufacture mechanical household refrigerators, the actual demand for refrigeration existing during the base period must be used. Reconstruction cannot be made on the basis of the demand for refrigeration as of December 31, 1939. In other words, whether the demand for the taxpayer's product or service is to be taken as it was during the base period or is to be reconstructed for the entire base period upon the basis of the demand existing as of December 31, 1939, depends upon the nature of the demand for the product in relation to the general market conditions, and not merely upon whether the taxpayer was a member of a new industry which commenced during, or immediately prior to the base period.

(iv) A situation analogous to (iii) above, but requiring certain *assumed* demand conditions, is presented by the following type of case:

The taxpayer commenced business during or immediately prior to the base period, manufacturing a newly invented product developed for use as a part of a final product made by another industry. The market for the taxpayer's product comprises, not the ultimate consumers, but the other industry using the product in its own manufacturing processes. The market is the secondary rather than the primary consumers' market, and the new product did not increase the final consumer demand.

Assume that the industry which buys the taxpayer's product is represented by case (iii) above. Although the demand for the new product did not actually exist before the development of the new invention, such demand was

in potential existence, since there was a demand for the product to which the invention pertains. The extent of the potential demand in earlier years can be ascertained, based on the sales of the complete products to consumers. This demand should be employed in the reconstruction; the assumption should not be made that no demand existed in earlier years, or that demand as it existed on December 31, 1939, should be used as the basis of reconstruction for the entire base period. Normal operating conditions for the taxpayer must be predicated upon the existence of an available market for the product, but only to the extent of the demand that was in potential existence. Illustrations of this type of situation follow:

A corporation engaged in research, manufacture, and sale of chemical products in 1938 developed a new fluid for use as hydraulic brake fluid in automobiles. Assume that automobiles generally were not equipped with hydraulic brakes until 1938, but before that time used mechanical brakes. There was no material demand in 1936 or 1937 for hydraulic brake fluid. To deny the existence of a demand for a product which was actually used during the base period, and for which a permanent use was established during such period, would not enable the base period to reflect the normal operation for the entire base period of the new or changed business. Therefore, the existence of a demand for hydraulic brake fluid must be assumed in 1936 and 1937. Such demand, however, must be based upon the number of cars actually manufactured and in use during those years, and cannot be predicated upon the number of cars manufactured and in use during 1939.

The same principles and result would follow if the product made by the taxpayer was used by the consumer as an additional part, rather than as a replacement. Thus, assume that self-starters for airplanes were developed and placed on the market in 1937. They were immediately used in the manufacture of airplanes, doing away with the necessity of hand-starting. If a taxpayer commenced business to manufacture self-starters in 1937, a demand for the product must be assumed to have existed in 1936, based upon the number of airplanes actually made that year which would have used such a product.

(v) There is one type of situation in which it may be proper to assume demand conditions for the entire base period with reference to demand conditions actually or constructively existing by December 31, 1939. Such a case is one in which the taxpayer is a member of a new industry making a new product or rendering a new service, where the industry commenced either during or immediately prior to the base period, and during that period was in its initial development stage.

In this type of situation, it must be determined that the introduction of the new product or service together with the sales promotion activities of the taxpayer created a new demand. Care must be taken to distinguish between the case described in (iv) above, where the product is a component of another product with an established demand, and the instant case where the new product or service actually creates the ultimate demand. In the former type of case, the ultimate demand is the one which must be considered. If the introduction of the component product or service does not have the effect of creating additional demand for the final product or service, the case falls under the principles discussed in (iii) and (iv) above. In rare instances, the new or different component may have the effect of creating additional demand for the final product. In such event, the case would be within the principles discussed under this type of situation.

If the introduction of the new product or service had occurred late in the base period with a consequent incomplete development of the demand, and if the demand would have been greater had the product or service been introduced earlier, the push-back rule may be used in determining the extent of the demand by December 31, 1939. This use, however, affords no grounds for departing from the actual market conditions and economic circumstances bearing on the industry in question which would limit the development of new demand in the two-year extended period. Moreover, it should be stressed that the taxpayer for which the demand is being constructively determined is the taxpayer as it existed at the end of the base period with the capacity actually existing, or constructively assumed to exist under the commitment rule, as of that date. Neither the physical characteristics of the taxpayer nor the general market conditions under which demand is to be constructively determined may be enlarged or modified by the application of the push-back rule.

As previously noted, the general market conditions existing by December 31, 1939, upon which base period market conditions may be predicated, must be normal market conditions. This means that abnormal circumstances having an effect upon the market as of that date must be eliminated. The demand must also be analyzed to determine that there is a presumption of permanence and continuance. Demand conditions which cannot be expected to represent normal demand conditions must be discounted. In the case of a new product, the first flush of demand may be based in part upon novelty and thus may represent a condition which cannot be considered to be normal. Likewise, the normal demand for the product or service must take into account the competitive nature of business activity.

The following example illustrates the type of situation in which it would be proper to reconstruct the demand throughout the entire base period upon the basis of demand as of December 31, 1939:

Assume that certain types of new and superior cold water paints were developed during the base period. A promotional period was necessary to obtain public acceptance, to demonstrate the superiority of the paints, and to prove their uses. During the development period the demand for these paints steadily increased until by December 31, 1939, the demand was larger than it had been at any previous time. It may fairly be determined that the introduction of cold water paints stimulated a new demand which was being developed during the base period. The use of actual total sales during the base period would thus not reflect normal operating conditions for the taxpayer. The demand during the base period may therefore be predicated upon the demand existing as of December 31, 1939. Even in this case, however, care must be taken to distinguish between the increase in demand created by the new product and the previously existing demand for paint, a portion of which the cold water paint would be able to capture and supply. Insofar as the latter demand is concerned, conditions during the base period must be taken as they actually existed. Insofar as the increase in demand is concerned, base period reconstruction may be predicated upon facts actually or constructively existing by December 31, 1939.

The discussion at this point has been designed to afford a basis for ascertaining the demand for the taxpayer's product or service, that is, the total quantity which can be sold, and the prices at which such quantity will be absorbed. The treatment of demand conditions has carried the theory of normal operating conditions to its logical conclusion. It has determined the demand throughout the base period not in the light of the developing and

expanding demand actually existing during the base period, but in the light of the demand existing actually or constructively by December 31, 1939. The problem here discussed is to be distinguished sharply from the establishment of the *portion* of the demand which the taxpayer will be able to secure for itself. This latter problem is now to be discussed under "Taxpayer's competitive position."

(c) *Taxpayer's competitive position.*

The previous discussion of market and demand conditions has been limited to the principles to be used in determining the demand throughout the base period for the product or service supplied by the taxpayer. The next problem to be discussed is the method of determining what share of that demand would normally be supplied by the taxpayer, and at what prices, or, in other words, the taxpayer's normal competitive position in its industry. The discussion will apply to both the use of the push-back rule and to the computation of normal earnings for the entire base period.

Section 722, as it existed prior to the amendments by the Revenue Act of 1942, required, in the case of a taxpayer that had changed its character prior to January 1, 1940, that it show what it would have earned in each base period year under conditions then actually prevailing. Section 722(a)(1)(A) required such a taxpayer to establish—

> "the amount that would have been its average base period net income * * * if the character of the business as of January 1, 1940, had been the same during each of the taxable years of such base period. * * *"

Section 722 as it exists today requires the taxpayer to establish the fair and just amount representing normal earnings based on normal operations throughout the entire base period. In some cases the determination of normal operating conditions and therefore normal earnings must be reached by the procedure detailed in the 1941 regulations under section 722 since such procedure results in normal earnings. In many other cases, however, this method would produce a distorted picture of the taxpayer's normal operations and therefore would not result in normal earnings.

There are *two general approaches* to the problem of determining the taxpayer's normal competitive position in its industry for the entire base period. The selection of the appropriate approach in a particular case can be made only by analyzing the relationship between the taxpayer and its industry, and the nature of the demand for the product or service.

(i) *First approach.*

The first approach requires that the taxpayer demonstrate saleability, that is, the portion of the demand which the taxpayer would have been able to capture during each of the base period years, if it had been in existence or changed in character during each of such years, under the actual general market conditions and the demand and internal operating conditions, which are assumed to be normal to the taxpayer.

This approach necessitates an analysis of the demand for the taxpayer's product in the base period, an examination of the competitive advantages or disadvantages of the taxpayer in relation to its competitors, and an evaluation of the sales and production policies of the taxpayer and its competitors. It is necessary to estimate the effect of the taxpayer's additional production upon industry selling prices, upon established selling and competitive practices, and possibly upon costs, particularly of labor and raw materials. In short, there

is required retrospectively precisely the type of prospective profits analysis which a prudent management would make prior to undertaking a change of the sort contemplated here.

This approach must be used in all cases in which the taxpayer has not proved that it has established itself as a stable member of its industry at a given competitive level, and that this competitive position would be maintained under demand and general market conditions comparable to those existing during the base period.

(ii) *Second approach.*

Under the second approach the portion of the demand to be attributed to the new or changed taxpayer for the entire base period is based upon inferences drawn from the performance of the taxpayer after the commencement or change but prior to January 1, 1940. In most cases, the portion of the demand captured by December 31, 1939 (either actually or as a result of the two-year push-back rule) would be based upon the relative portion of the actual or constructive demand which the taxpayer would have captured in each of the base period years had it been in existence in its changed character during those years. If, for example, in 1939 the taxpayer was able to capture and supply 15 percent of the demand for its product, it may be assumed to have been able to capture and supply 15 percent of the demand for its product in each of the base period years at the then prevailing prices.

This approach is to be employed only in those cases where it is established that the taxpayer has, as of the close of the base period, actually, or constructively (by application of the two-year push-back rule), won a stable competitive position in its industry in one of the following types of situations:

1. The taxpayer has established its ability to capture a given portion of the demand under normal conditions without resort to disruptive competition. In short, the taxpayer became an accepted member of an industry which is not necessarily expanding or subject to rapid turnover of members.

2. The taxpayer has, in effect, replaced other members of the industry and has demonstrated ability to secure and hold a given portion of the demand under normal conditions without resort to disruptive competition. The industry normally experiences a turnover of membership, some concerns vanishing from the field and others taking their place.

3. The taxpayer has established its ability to maintain its relative competitive position under conditions of a growing and expanding demand without resort to disruptive competition.

The employment of the second approach will necessarily be based upon certain assumptions with respect to the taxpayer's ability to supply during the entire base period the same portion of the demand as it did after the commencement or change. It will be necessary that careful study be given to the taxpayer and its industry to determine whether these assumptions are realistic. Where the second approach is employed one or more of the following assumptions will have been made:

1. The actual total demand for the product or service of the taxpayer would have shown only normal fluctuations in each of the base period years, but the taxpayer would have invaded the market and would have captured at the prevailing prices a portion of the demand supplied by the then existing members of the industry.

2. The actual demand for the product or service of the taxpayer would have shown only normal fluctuations in each of the base period years (i.e.,

would have reflected general market conditions) but the taxpayer, by replacing other corporations which have ceased to be members of the industry, is considered to have supplied that portion of the demand formerly supplied by the other corporations.

3. The actual demand for the product or service of the taxpayer would have been increasing during the base period years, not as a result of normal growth of the industry, but because new developments occurring late in the base period resulted in an expansion of both industry and demand in a period of initial development. The expanded demand is deemed to have existed in the base period years as a normal condition under which the taxpayer's normal earnings are to be constructed. The taxpayer has actually, or constructively under the two-year push-back rule, been ascertained to have captured a certain portion of this expanded demand.

In addition to these conditions, this approach makes the additional supposition that the taxpayer could have sold its product or service at the price level existing during the base period years and would not have had to reduce prices so as to be able to capture a portion of the demand. Whereas this supposition might in some cases be unrealistic under the first situation described above, it is entirely consistent with the second and third situations. It postulates the acceptance of the taxpayer by the industry as a competitor at exising levels of competition. In other words, it ignores the possibility that the additional supply thrust upon the market by the taxpayer might have resulted in price demoralization.

(iii) *Illustrations.*

1. An industry is stable, with a stable demand for its product. New members rarely enter the industry and are subject to intensive competition. The industry usually operates at about half its capacity. In 1939 the demand for the product expanded rapidly. In that year the taxpayer was formed by one of the employees of an old member of the industry in order to obtain the high current profits. Since the unusually good 1939 market conditions were not representative of average base period conditions there is no reason to assume that 1939 conditions would constitute normal operating conditions for the taxpayer and therefore should be presumed to exist in 1936, 1937 and 1938 for the purposes of reconstruction. Since 1939 conditions furnish no criterion of the taxpayer's ability to compete under conditions in prior years with the same degree of success, and the taxpayer might not even have been in business under such pre-1939 conditions, it is necessary to treat it under the first approach and require it to establish what it could have earned in actual competition under pre-1939 conditions.

This requirement would apply in the same manner in the case of an existing taxpayer which expanded its capacity in similar circumstances.

2. Suppose that the industry is the same as that described in the preceding illustration, but the entry of the taxpayer into the industry was not dependent upon unusually good market conditions. In such circumstances, in order to realize any earnings, the taxpayer must capture a portion of the demand supplied by other members of the industry at a price which would yield it a profit. These circumstances represent normal competitive conditions for the taxpayer. It is therefore entirely appropriate to require it to establish under the first approach what portion of the industry sales it would have made and at what prices, in order to establish its normal earnings. If after a substantial period of actual operations prior to January 1, 1940, the taxpayer has demonstrated its

ability to sell given quantities at given prices, its normal earnings for each base period year should be reconstructed under the second approach upon the basis of the relative competitive position so secured.

The more difficult case will occur where the taxpayer has commenced business late in the base period and is not able to demonstrate its competitive ability on the basis of its actual experience prior to January 1, 1940. In such a case, however, its competitive ability must be established by other means. It may be that in some cases the taxpayer entered the industry late in the base period with a view to future war profits, and that under normal circumstances it would never be able to acquire a stable competitive position in the industry.

3. Another type of situation is that of the "world-beater" product. The taxpayer produces a product to supply an existing demand, but such product is so superior that a larger demand is promptly developed. This is not a case where the expansion of demand for the product arises from the development of new or different uses. It is a case where an existing need which could not have been satisfied by the old product, and which therefore did not amount to a demand for the old product, is satisfied by a new product. To compute normal earnings in such a case it would be necessary to carry back into each of the base period years the new demand which this product has called out. This assumption of demand throughout the base period has been discussed above under "General market conditions and demand for products or services." In this type of case the taxpayer's competitive position established as of December 31, 1939 may be used under the second approach for the entire base period.

At least two qualifications should be added to the solution suggested here. First, there will be many instances (possibly a majority) where the "world-beater" product will give the taxpayer only a temporary advantage until the balance of the industry overtakes it with like products. In such instances, the capture and retention of the entire increased demand or of all the previously existing demand would not be normal. Normal operating conditions would reflect a greater demand than formerly existed, but one shared by the entire industry. Second, the new demand must be in existence, actually or constructively, by December 31, 1939 and under general market conditions then existing. Changes in the character of a business made in anticipation of an enlarged post-1939 market cannot serve as the basis for relief.

4. Another situation arises in an industry characterized by constant changes in its membership, irrespective of general market or specific demand conditions. Some entering members may become permanent, but in the normal course of events it is to be expected that the mortality rate of newcomers will be high. The stronger and weaker newcomers should be treated differently so far as assuming that operating conditions at December 31, 1939 do or do not represent normal operating conditions for the entire base period. In other words, it will be necessary to treat certain of the newcomers under the first approach, and certain others under the second approach.

It is not possible to formulate any general objective tests upon which the determination here required may be based. It is suggested, however, that the observable characteristics of the taxpayer's business may provide a sufficient guide in many cases. For example:

a. The beginning taxpayer may have inadequate working capital or an inefficient plant, or be unfavorably situated in relation to its competitors. It may be determined historically that newcomers so situated have suffered a high percentage of ultimate failure. If this is found to be true it will not

be proper to assume that the taxpayer's operating conditions at the end of its base period constitute its normal operating conditions for its entire base period. Such a taxpayer should be treated under the first approach.

b. The taxpayer's customer is one which is known to encourage the entrance of newcomers into the taxpayer's industry. It is the policy of the customer to promote price competition among its suppliers by temporarily shifting its purchases to newcomers, and reverting to its original suppliers after price competition is established. A beginning taxpayer operating under such conditions should be treated under the first approach.

c. The entering taxpayer may have apparently carved out a competitive place for itself in its industry by supplying a demand temporarily neglected by its competitors for a different and more profitable field. If the probability can be established that these competitors may reenter the taxpayer's field at any time, it will not be proper to assume that the operating conditions of the beginning taxpayer are normal, and the first approach should be used.

In the case of a taxpayer in an industry such as is here under discussion, the possibility of the existence of the foregoing circumstances must be examined. Only if it can fairly be stated that no such circumstances exist, may the taxpayer be treated under the second approach.

5. An important type of case involves a growing industry in its initial development period, with the taxpayer's entry timed to, and based upon, certain market and demand conditions then in existence. If such conditions can be considered normal, reconstruction for the taxpayer should be based upon those demand conditions adjusted to industry experience and general market conditions throughout the base period. It is important that these market and demand conditions be adjudged permanent, since the approach to this type of case is predicated upon the theory that a new and permanent level of operating conditions has come into being, and that the taxpayer's normal earnings should be computed upon the basis of such new level. If the larger demand were temporary, no new level of operating conditions could be said to have been established under which the taxpayer's activities could normally be carried on. Such conditions, being transitory, could not establish a new level of normal conditions.

This type of case presupposes the expansion of demand to a point where the existing members of the industry would not be capable of supplying it under regular operating conditions. It does not include a case where the existing industry members can supply such demand. If the taxpayer attempted to enter the industry under such latter condition, it would, in effect, be similar to an attempt to break into a stable industry, as an illustration 1, and normal earnings for the taxpayer would then be based upon the portion of the existing demand it could take away from the other industry members and the additional demand it could create and supply.

In this situation, however, the taxpayer is operating under new general market conditions which will be permanent. These are the minimum conditions which called it into being. To force it to establish earnings based upon operating conditions involving both a smaller demand and competition with other industry members to supply that smaller demand, under which conditions it would never have been formed, would be to base earnings upon abnormal rather than normal operating conditions.

Accordingly, if the taxpayer is a member of an expanding industry and both industry and taxpayer are in their initial development period, and if the taxpayer comes into existence as the result of certain conditions of a permanent nature giving rise to a larger demand, it is proper under the second approach to predicate the taxpayer's base period competitive position upon its position as of December 31, 1939.

(3) *Statutory basis for determining normal earnings.*

Under the statute the constructive average base period net income must reflect the normal operation of the business for the entire base period. As a practical matter, this requires that normal earnings attributable to normal operating conditions at the end of the base period must first be established under the push-back rule. Therefore, if the earning level attained at the end of the base period is less than the level it would have reached had the commencement or change been made two years earlier, the taxpayer is given an additional period of two years within the framework of base period conditions to establish what the earning level at the end of the base period would have been after such additional period.

The basic steps in the computation of normal earnings are, therefore, the following:

(a) Determine whether by the end of the base period the taxpayer has reached the level of earnings it would have reached had it commenced business or made the change two years before it did.

(b) If this determination is in the negative, determine what the normal earning level would have been at the end of the base period if the business had been commenced or changed in character two years earlier.

(c) Having determined normal earnings as of the end of the base period, compute normal earnings for the entire base period based on normal conditions for the entire base period.

(a) *Determination of the applicability of the push-back rule.*

As has been pointed out, it is not theoretically possible to determine that the taxpayer has reached by the end of its base period the level of normal earnings it would have reached under the push-back provision without making a computation under that provision. There will be many cases, however, in which such a computation will not be necessary because it will be clear that the full benefit of the qualifying section 722(b)(4) change or commencement has been realized by the end of the base period. This is likely to be true, for example, in the following kinds of cases:

(i) A taxpayer changes its character by a complete revision of its production technique. A new productive process is adopted, new machinery is installed throughout the plant, and as a result of these changes costs are substantially reduced. The taxpayer's selling prices remain the same. The full benefit of these changes is realized as soon as the plant has gone through its shakedown experience and is running at normal efficiency.

(ii) A taxpayer takes over the going business of a competitor. The effect of the change is not to increase selling prices, but simply to expand operations and reduce operating costs. The full effect of the change may be realized as soon as duplicated functions of the combined businesses have been eliminated.

(iii) A taxpayer builds a new plant to produce a specialty in urgent demand. The plant is utilized to capacity from the beginning of its operations, and the profit benefit from it is immediately realized.

(iv) The taxpayer's actual experience before the end of the base period is long enough so that it may be said that the initial development difficulties arising from the commencement or change in the character of the business have been concluded.

(v) A taxpayer whose goodwill and trade name have been firmly established with respect to its product opens new units for the manufacture or distribution at wholesale or retail of such products, and experiences no initial development difficulties in marketing its established products.

In cases such as the above, it may be possible to proceed immediately to construct income for the entire base period without the use of the push-back rule. Since, however, many of the cases may not fall into these categories, and since the push-back rule poses difficult problems, it is necessary to discuss the theory and background of the rule.

(b) *Purpose and application of the push-back rule.*

The push-back rule is designed to enable the taxpayer to overcome constructively its initial development difficulties. Stated most directly, it is intended to give the taxpayer two additional years of experience under normal base period conditions to demonstrate its normal operating costs and normal competitive position in its industry. Its purpose is definite and restricted; it may not be used other than as an essential step in the reconstruction of normal earnings for the business entitled to relief.

The following principles must be observed in applying the two-year push-back rule:

(i) Normal earnings under section 722 must be determined in the light of general economic conditions which existed by December 31, 1939. Economic conditions after that date cannot be taken into account. Therefore, the rule may not be used to develop the general market conditions under which the taxpayer will operate, although it may be used in a proper case in the determination of constructive demand for the taxpayer's product or service under actual market conditions.

(ii) The push-back rule cannot be used to qualify changes not made (actually or constructively under the commitment rule) by December 31, 1939. Thus, a taxpayer which changed its product in January, 1939 cannot reconstruct base period income on the theory that had it introduced its new product two years earlier, various other consequences, such as increases in capacity, would also have occurred. Changes, innovations, additions, new processes, new products, new facilities, or any other factor which was not present actually or constructively by December 31, 1939, cannot be brought into the picture in determining what constitutes the changed business for which normal earnings are to be established.

(iii) In applying the push-back rule, no assumptions may be made as to what constitutes the taxpayer's normal competitive position in its industry. The push-back provisions are merely a part of the process of determining normal operating conditions. Accordingly, the taxpayer must establish, in the light of the determined demand, the share it would normally secure by the end of the base period.

(iv) The push-back rule is not intended to extend the normal growth of a taxpayer for an additional two years. Thus, a taxpayer may have been

enjoying normal growth throughout the base period and in addition may have made a section 722(b)(4) qualifying change. If the benefits of the change are fully reflected in earnings at the end of the base period, no increase in this earning level can be allowed on the theory that with two years added experience normal growth would have resulted in higher earnings. The push-back rule is intended only to give the taxpayer two more years to overcome initial development experience.

(v) The push-back rule is not designed to limit reconstruction to the two years prior to the qualifying change. Reconstruction under section 722(b)(4), as in other paragraphs of the section, must in every case be made for the entire base period. Thus, in the case of a taxpayer making a change at January 1, 1939, there is no warrant under section 722 for reconstructing 1937 and 1938, leaving 1936 unchanged, and then applying the growth formula of section 713(f) in computing the constructive average base period net income.

(vi) The earning level at the end of the base period determined under the push-back rule is not to be taken as representing normal earnings for the entire base period.

(vii) All new factors affecting production or operation which constitute reasons for relief, and all limiting factors upon production or operation, the removal of which is the reason for relief, are to be considered to have existed (or not to have existed) throughout the push-back period depending upon whether they existed (or not) as of December 31, 1939. Thus, impediments to production, the removal of which changed the character of the business by changing the nature of the operations, must be considered never to have existed. The new capacity giving rise to relief must be considered to have existed throughout the push-back period. Similar assumptions must be made with respect to all the reasons for relief.

(viii) The taxpayer's normal competitive position and its normal operating costs are not necessarily to be determined by reference to the last full base period year of expanded experience, but by reference to the facts as they existed toward December 31, 1939. Normal operating conditions may be determined in the light of data and information for the shortest period ending at December 31, 1939 which truly reflects such conditions for the taxpayer. The early part of the last base period year, however, may be a period of development and may not truly represent normal operating conditions. Unless it is demonstrated that such is the case, the entire last base period year should be used. The last quarter of 1939, alone, may be unreliable because of the effects of the European war.

(ix) Under no circumstances is the push-back rule to be applied by assuming that the first two excess profits tax taxable years represent the extended period, or that the income for those years, adjusted or unadjusted, is to be used in determining the earning level as of December 31, 1939.

The aspects of the taxpayer's operations which may be normalized by the use of the push-back rule are its internal operating conditions, as reflected in its costs, its competitive position in its industry and the demand for its products or services, as reflected in its sales. Some cases will involve all aspects, others only one or two.

In applying the push-back rule to determine the normal operating conditions of the taxpayer, consideration should be given to such factors as the type of operations engaged in by the taxpayer, to the stage of its actual development by December 31, 1939, to its prior rate of development, and to its future prospects under normal conditions as such prospects actually existed at December 31, 1939. When cost factors are to be ascertained, pertinent considerations may include the efficiency of the labor force, the manner in which the equipment is operated, the relationship between actual production and capacity of the business, and the relationship between the operations of the taxpayer and those of other members of its industry. When the taxpayer's competitive position is to be ascertained, pertinent factors may include the taxpayer's position in its industry with respect to that portion of the business which is not changed, the reasons for the change in character or the commencement of business, the relationship between the taxpayer's sales and its capacity to produce, its relationship to other members of its industry, the prevailing competitive practices, the sales policies of the taxpayer, and the nature of demand conditions for the product or services furnished.

When the demand for the taxpayer's product must be determined, pertinent considerations may include the nature of and uses for the product, the advertising and sales promotion policies of the taxpayer, and the responsiveness of sales to changes in price.

In determining what the taxpayer's internal operating conditions, demand for its product, and its competitive industry position would have been by December 31, 1939, had it commenced business or made the change in character two years before it did, the principles and rules discussed under "Determination of normal operating conditions" must be observed. Thus, if the taxpayer is able to use the second approach in reconstructing its normal competitive industry position, its competitive position actually attained by December 31, 1939 may be taken into consideration as a factor in determining what its normal position would have been as of the close of the base period under the push-back rule. If the taxpayer must use the first approach, a more detailed analysis must be made in order to ascertain what that normal position would have been.

No hard and fast rules may be prescribed to govern determination of normal operating conditions. Pure speculation, however, is not warranted. Such determination should be made in the light of ordinary and reasonable business experience as applied to particular cases.

(c) *Computation of normal earnings for entire base period.*

Once normal operating conditions as of December 31, 1939, have been determined, an amount of excess profits net income can be computed upon the basis of such conditions through the conversion of sales volume into gross receipts and the ascertainment of normal costs and expenses. The next step is to proceed with the reconstruction for the entire base period.

If the taxpayer is required to use the first approach described in "Taxpayer's competitive position" under which it must establish the volume of sales it would have been able to make in each base period year as it may actually or, under the push-back rule, constructively constituted as of December 31, 1939, a detailed determination of normal operating conditions and normal earnings must be made for each base period year.

If the taxpayer is able to use the second approach, under which its competitive position throughout the base period will be assumed to be the position

which it is determined to have secured actually or constructively by the end of its base period, a detailed determination of normal operating conditions for each base period year will not be necessary. In such event the normal operating conditions and earnings existing actually or constructively, as of the end of its base period will serve as the point of departure for the reconstruction for the entire base period.

(C) Methods and techniques of reconstruction.

The first step in actual reconstruction is to determine the normal operating conditions for the particular taxpayer. The next step is to translate these conditions into a fair and just amount representing normal earnings. To accomplish these steps, certain methods and techniques must be utilized in the determination of net income, both in the application of the push-back rule and in the reconstruction for the entire base period.

Net income may be reconstructed as a single amount or it may be reconstructed to show, in greater or less detail, the various items of income and deductions comprising the net income. The net income or its component items must in turn be obtained from certain sources of information which show what items of income or deductions or net income would result from the determined normal operating conditions. These sources of information are chiefly the taxpayer's own experience and the experience of comparable concerns. Finally, these sources of information may indicate the actual dollar amount of income, deductions, or net income that would result from the determined operating conditions. Or they may indicate the ratios existing between the income, deductions, or net income of comparable concerns and of the taxpayer for which reconstruction is to be made. Similarly, ratios may be obtained between various items of income and deduction entering into the net income of either the taxpayer or a comparable concern.

(1) *Sources of information.*

The basic objective of any method of reconstruction is to translate normal operating conditions into income, deductions, or net income. Therefore, any technique is acceptable which shows the amount of net income which would result from the established normal operating conditions, provided that such technique reflects the application of sound accounting and economic principles to the facts in the particular case. In a given case, several different techniques and several sources of information may be utilized in order to obtain the final result. No one technique or source of information may be said to be generally preferable to another, except insofar as one may be peculiarly adapted to reflect a particular kind of change in character or a particular item of income or deduction. Thus, in reconstructing for a taxpayer which commenced business during the base period, volume of sales and selling price may be ascertained from an analysis of the taxpayer's gross income from sales during the base period, if such gross income fully reflects its competitive practices and the experience and efficiency of its sales force. At the same time cost of goods sold might be based on the experience of other members of the industry if the taxpayer's own experience in this respect is inadequate, but will, after development, follow the experience of such other members by reason of similarity in manufacturing processes, sources of raw materials, labor and indirect manufacturing costs or by reason of measurable differences in these components of manufacturing costs and costs of sales. Similar considerations are pertinent to taxpayers not engaged in manufacturing.

The sources of information to be used in reconstruction are as follows:

The operations, income, deductions, or net income of *the taxpayer* before and after the change in character or after its commencement of business;

The operations, income, deductions, or net income of *another concern*, the normal operating conditions of which are identical with, or bear an established relationship to, the normal operating conditions of the taxpayer;

The operations, income, deductions, or net income of *several* such comparable concerns or the taxpayer's *industry;* and

Pertinent *economic and business data* of general applicability, such as sales and price indexes, prevailing wage rates, cost of materials, rates of depreciation and rates of taxes, which are related to the taxpayer's business.

(a) *The operations, income, deductions, or net income of the taxpayer.*

When the taxpayer has had experience either before or after the change in character, or after the commencement of business, which is pertinent to the reconstruction, such experience is always more reliable as a source of information than is the experience of other businesses. Fewer problems of comparability of normal operating conditions are presented. There is greater assurance that special operating conditions inherent in the business, but not readily apparent, are reflected in the income or deductions used in the reconstruction. This source of information is especially desirable where policy questions are involved affecting sales; and where an increase in capacity for production of existing products or a change in operation of the business is involved. Finally, with respect to items unique in the taxpayer's own business, its own experience may be the only reliable source of information.

In some instances, actual dollar amounts of income or deductions of the taxpayer may be used. Thus, if a taxpayer, as an incident to an increase in capacity, rented an additional building, the actual monthly rental would be used as a deduction in the reconstruction. In other cases the taxpayer's income or deductions may be expressed as a ratio to other items of income or deductions. For example, assume that during the base period the taxpayer began the manufacture of a new product for which additional plant capacity was installed. This new product was directly related to the old, but its introduction neither retarded nor stimulated sales of the old product. By the end of the base period sales of the new product had reached a constant ratio to sales of the old product of approximately 25 percent. This ratio might be applied to sales of the old product in each base period year to reconstruct sales of the new product, thus measuring the volume of sales attributable to the added capacity.

(b) *The operations, income, deductions, or net income of another concern.*

Where the changed business of the taxpayer is dissimilar to its prior operations, or where the taxpayer has commenced business, it may be possible to select another business in an industry of which the taxpayer is a member, the normal operating conditions of which are substantially similar to, or bear an established relationship to, the normal operating conditions of the taxpayer. The point to be emphasized in the selection of a comparable concern is that the similarity of one or more of the relevant normal operating conditions must be clearly established before the use of its income, deductions or net income reflecting these conditions is warranted. Thus, assume that

the taxpayer which commenced business during the base period, is one of several companies licensed to manufacture a product under the same patented process. Even though their normal competitive positions are different their similar internal operating conditions, including substantially the same volume of production, may permit the use by the taxpayer of the unit cost of goods sold of one of the other concerns using the same process. To the extent that the internal operating conditions of the taxpayer and of another concern are similar, this technique may be proper even though the ultimate products manufactured are different. Thus, if a taxpayer manufacturing plastics from purchased chemicals changes its character by adding facilities to produce such chemicals, the cost of manufacture of the chemicals by another concern engaged solely in their production might be used in the reconstruction. Likewise, advertising and promotional expenses of another business which entered the market earlier than the taxpayer might be used in determining the advertising and promotional expenses to be borne by the taxpayer.

In the preceding illustrations the actual dollar amounts of income or deductions were used where the normal operating conditions of the comparable concern were found to be identical with those of the taxpayer. It is not necessary that identity be established. In some instances, it may be possible to find a comparable concern the normal operating conditions of which bear an established relationship to the normal operating conditions of the taxpayer. In such cases, ratios between corresponding income and deductions of the taxpayer and the comparable concern may be used in the reconstruction. Thus, in the illustration given above of the companies manufacturing the same product under a license, it may be found that the taxpayer had sales of approximately 50 percent of the sales of another concern at the same stage of development. This relationship would have to be adjusted to take into account any difference between the economic conditions which the corporations encountered in the respective years in which they commenced business. The ratio, thus adjusted, might be applied to the sales of the comparable concern in order to determine reconstructed sales of the taxpayer. This technique might be employed both for the purpose of the push-back rule and for reconstruction of the entire base period.

It should be noted, however, that the fact of an established relationship for one operating condition does not imply the same relationship for other operating conditions. Thus, in the above illustration, the adjusted ratio of sales would not necessarily apply to determine cost of goods sold. It would therefore be improper to apply this ratio to determine gross profit on sales, unless both the ratio of sales and cost of goods sold between the two concerns were approximately the same.

The same observation might be made as to ratios between items of income and deductions of the taxpayer itself. A 50 percent increase in capacity will not produce a 50 percent increase in income unless sales and cost of goods sold vary proportionately with capacity.

(c) *The operations, income, deductions, or net income of several comparable concerns, or the taxpayer's industry.*

In many cases a more reliable picture of the constructive experience of the taxpayer may be obtained by reference to a group of comparable concerns. This is likely to be true when no single concern can be found which is closely similar to the taxpayer in all essential respects, but where several concerns have resemblances in the various characteristics that are pertinent.

The use of several comparable concerns may serve to average out the amount of income or deductions which would result from normal operating conditions which appear to be identical. It may not be possible to analyze normal operating conditions of the taxpayer so accurately that their results can be translated into income and deductions within a narrow margin of error. The use of several comparable taxpayers serves to minimize this margin of error. Such use also lessens the effect of any special operating conditions affecting a single comparable concern which might be reflected in the income and deductions to be attributed to the taxpayer.

The point to be emphasized is that the use of several comparable taxpayers should not be permitted to average out differences in *normal operating conditions.* Such procedure would result in average earnings of the comparatives rather than normal earnings for the taxpayer. If there is a substantial divergence in normal operating conditions, as between the taxpayer and the comparatives, the income and deductions or net income of the comparative businesses can be used only by means of established ratios of relationship to the taxpayer. If the taxpayer is qualified for relief and if its experience and background are insufficient to demonstrate a definite superiority or inferiority, reconstruction based upon a single concern which might be superior or inferior cannot be justified, and the average experience of several representative concerns may furnish a reliable measure of the constructive experience to be attributed to the taxpayer.

The use of a number of comparative concerns rather than a single business may involve some grouping of profit and loss items for comparison with the taxpayer's business. Complete detail of comparison not only would require data not usually obtainable, but in many cases would be undesirable because of noncomparability of detailed operations. For instance, the use of selling costs per unit, and administrative costs per unit will often be more practicable and desirable than the use of each item of each class.

The members of the taxpayer's industry all operate under conditions which are similar in some respects, so that the use of industry data is merely an extension of the use of several selected comparative corporations previously described. Moreover, industry data may be more readily available in studies or publications of trade associations or of public agencies than data for a segment of the industry. Since the normal operating conditions of all members of the industry are likely to be more widely divergent than a selected segment thereof, the same caution as noted above should be observed in the use of industry data. Indiscriminate use of such data would serve to give a particular taxpayer merely the average for the industry instead of earnings which are normal for it. This would discriminate against a taxpayer which is above the average of its industry and would favor a taxpayer which is below such average. The reference to industry data, therefore, is justified only in the case of a well-knit, homogeneous industry where the taxpayer can be demonstrated to be typical of its industry.

The use of industry data is especially appropriate to measure the broad fluctuations of economic conditions between different base period years and the determination of demand conditions. Its use may be appropriate in the case of a change in products furnished, and also in the reconstruction for the entire base period after the push-back rule has been applied. Obviously, dollar amounts of industry income cannot be used. This source of information can therefore be used only through the development of ratios.

(d) *General economic and business data.*

If the experience of the taxpayer or that of comparable concerns is inadequate as a basis for reconstruction of income and deduction items, recourse may be had to various types of business and economic data for more general scope. Moreover, reference may be made to such data for confirmation of income and deduction items reconstructed on the basis of data derived from other sources.

General business and economic data are particularly pertinent to the problem of the extent of the demand for the taxpayer's products and services. For example, a publishing company introduces a new journal, the subject matter of which deals primarily with technical architectural matters, and which is distributed nationally. The subscribers to this publication would be restricted largely to professional architects. In constructing the volume of subscribers to this journal, regard might be had to the number of licensed architects and to the activity in the construction field during base period years.

General data may also be useful as a basis for inferences regarding the internal operating conditions of the taxpayer. An example is rates of depreciation, taken from engineering studies on various types of equipment. Another illustration is state income tax legislation and local property assessments and tax rates. Again, wage rates prevailing in a particular area might be used in the computation of the labor cost items for the taxpayer.

Pertinent general business and economic data may be obtained from a variety of sources, both governmental and private. The reports and studies of Federal agencies are especially helpful as a source of nation-wide data. Various private organizations, such as trade associations, research foundations, and educational institutions, also compile data on a nation-wide basis. Likewise, the publications of trade and professional organizations or associations may furnish valuable information regarding the developments and prospects in lines of business that affect the taxpayer. No reliable source of information should be neglected that may be indicative of the economic climate in which the changed taxpayer would operate.

Need will frequently arise for general data of limited geographic scope, such as by regions, states or metropolitan districts. Such data may in some cases be obtained from breakdowns of nation-wide statistics. In other instances, data may be available that are compiled on a localized basis by various organizations of limited coverage. Such sources might include state and local chambers of commerce, business research bureaus of colleges and universities, or regional business associations.

(2) *Reconstruction of net income.*

As was indicated above, the reconstruction may be made in detail for each item of income and deductions entering into net income. On the other hand, certain groups of income or groups of deductions may be determined as a single amount. Finally, net income may be determined as a single amount. The major items or groupings of items of income and deductions appearing on a profit and loss statement are net sales, cost of goods sold, gross profit on sales, selling expense, administrative expense, general expense, net operating profit, non-operating income and expense, and net income. Any of these items may be determined in detail or as a single amount, provided the underlying normal operating conditions are properly reflected. Data pertaining to these items are obtainable from the various sources of information discussed above.

(a) *Computation in detail of each item of income and deduction.*

Basically, there is only one method of reconstructing net income and that is by reconstructing each item of income and deduction separately. Resort should be had to the short-cut technique of reconstructing groups of items only when so little is known of the conditions influencing the detailed accounts as to subject detailed reconstruction to a wide margin of error. In no case should the short-cut technique be considered to be an alternative method for the construction of normal earnings. It is simply a practical device to be employed when it has been determined (1) that detailed accounts cannot be reconstructed accurately, and (2) that an aggregate of operating conditions of the taxpayer may be reflected by an aggregate of accounts representing similar experience either of other parts of the taxpayer's business or of other concerns.

Two major considerations bear upon the question of the degree of detail necessary and desirable in the reconstruction of income. First, it should be noted that the reconstruction of accounts in detail is not a guarantee of accuracy. Unless the conditions bearing upon each account are known or can be estimated with reasonable accuracy, the resulting errors in individual accounts may, although slight in themselves, give a grossly inaccurate result when combined in a net income computation. Second, it must be kept in mind that the reconstruction of a number of accounts in a group may conceal significant differences in operating conditions as between the new aspects of the taxpayer's business and the operations which are used as a basis for comparison. Consequently, in every case in which accounts are reconstructed as a group, care must be exercised in testing the detailed operating conditions in order to isolate and adjust for such differences.

(b) *Use of gross profit ratios.*

This technique has two aspects depending upon whether it is based upon net sales or upon sales volume. In either event, sales or sales volume must first be reconstructed. Ordinarily, the volume of sales must be determined by reference to the principles set forth in "Taxpayer's competitive position." In the case of new products or products, the demand for which is expanding, reference may also be necessary to "General market conditions and demand for products or services." Gross sales may be determined on the basis of the taxpayer's own policies with respect to sales prices. Sales returns and allowances may be determined from the taxpayer's experience or that of comparable concerns. The resulting net sales may then be used for the reconstruction of gross profit on sales. In some cases, as for example, in the case of chain stores, the taxpayer's net sales may be determined as a single amount directly by reference to other stores selling the same type of product under identical general market and competitive conditions.

If the reconstruction is based upon sales volume, reconstruction of gross profit per unit of sales presupposes that the taxpayer and the "comparative" had the same gross profit per unit. The term "comparative" as thus used may mean the taxpayer's own experience or the experience of some comparable concern, whichever source of information is used. Thus, in the preceding example, the taxpayer's own experience with its old stores may be the "comparative" for reconstruction for the new store. Where the sales prices of the "comparative" are the same as those of the taxpayer, this technique is proper only when the unit costs of goods sold of the taxpayer and the "comparative" are the same. For example, a taxpayer may increase its capacity and thereby increase its production without increasing certain fixed or semi-

fixed overhead manufacturing expenses. Assume that after the change its unit cost for its total production, including the use of the new capacity, is reduced because overhead is absorbed by a larger number of units produced. It would therefore be improper to apply the gross profit per unit prior to the change to the reconstructed volume after the change unless the selling price of the entire volume has been reduced.

A reconstruction based on a certain percentage of gross profit per dollar of sales presupposes that changes in cost of goods sold will be offset by corresponding changes in selling price so that the gross profit ratio will remain unchanged. This may be a realistic assumption in a competitive industry in which reductions in cost are ordinarily accompanied by reductions in selling price. In such cases, this technique may be more reliable than the separate determination of selling price and cost of goods sold. However, in using a ratio of gross profit to dollar sales of another concern, care must be taken that the manufacturing processes of such other concern are the same as those of the taxpayer and that the underlying assumptions as to the relationship of costs, selling price, and volume are correct. The relative size of the taxpayer and the "comparative" may be such that cost saving through absorption of overhead is not properly reflected in the experience of the "comparative."

(c) *Use of net operating profit or net income ratios.*

This technique is essentially the same as that described in (b) above, with the exception that the ratio used is that of net income, rather than gross profit, to sales or volume. A distinction between net operating profit and net income is necessary only in the case of a business which shows substantial amounts of nonoperating income or expense. Since net operating profit or net income is determined after deduction for selling, administrative and general expenses, this technique presupposes that such expenses, as well as cost of goods sold, will vary proportionately with dollar sales or sales volume. In the case of an increase in capacity or the addition of a new product, the taxpayer's selling, administrative and general expenses will rarely increase in exact proportion to an increase in its sales. The use of a ratio of net income to sales based on its own experience prior to the change would therefore usually be incorrect. An exception might be found in some cases, such as a contracting company operating on a cost-plus basis, under which gross income (and net income) is a fixed percentage of total costs of operation.

When the ratio of net income to sales is obtained from one or more comparable concerns, the underlying assumption is made that the comparable businesses are so like the taxpayer's that the same rate of return on net sales is representative of the taxpayer's business as changed. A selective grouping of comparable concerns, the normal operating conditions of which most closely correspond to those of the taxpayer, must be made if a ratio of net income to sales is to be used. Net income reflects differences in volume of sales, selling price and costs, and blends the effects of all the operating conditions under which a business operates. Where these conditions for the comparable concern have been analyzed and shown to bear a known relationship to those of the taxpayer, the ratio of net income to sales may be properly used as a technique of reconstruction.

(d) *Tests and checks to be applied to the constructive average base period net income.*

(i) *In general.*

Whatever sources of information are used, or whatever techniques are employed in the reconstruction, the results should be tested and checked by the

use of other sources of information or other techniques. Any technique, based upon any information, makes certain assumptions and judgments as to normal operating conditions of the taxpayer (internal operating conditions, demand, and competitive position) under its new or changed character, and as to what experience is applicable. The accuracy of these assumptions and judgments, whether explicit or implicit, should be tested by examining the reasonableness of the end result, comparing it either with over-all experience of the taxpayer's industry, or, in proper cases, with the taxpayer's prior experience. At least two major types of checks can be suggested.

(ii) *Ratios based on sales.*

For example, if a detailed reconstruction is made, based in part upon the taxpayer's own experience and in part upon the experience of comparable concerns, comparison of the reconstructed ratio of gross profit to sales with the taxpayer's actual gross profit ratio and that of its industry might be made. If such comparison indicates a result out of line with the experience of the taxpayer and its industry, it may be presumed that some error has been made in the determinations of normal earnings. This error may have been made either in the determination of normal operating conditions or in the translation of such conditions into net income. This presumption can be overcome by the establishment of some definite advantage or disadvantage of the changed taxpayer compared with its industry or with itself prior to the change.

(iii) *Ratios based on investments.*

The rate of return on capital employed on the business is the most significant general measure of earning power. If capital is an important factor and the business is competitive, the average rate of return possible over a period of years is definitely limited by the force of competition. In many industries the average annual rates earned by concerns which have passed the period of initial development tend to settle within a well-defined band which rises as the industry prospers and falls when it is beset by hard times. Many concerns tend to maintain relatively fixed positions in such a band, as average profit makers, or as leaders or laggards in this respect.

Accordingly, it is desirable in all reconstructions, provided that capital is an important income-producing element, to consider the ratios of constructive net income to the capital invested in the business after the change in character. If these ratios should fall far outside the profit band that represents industry experience, that of comparable concerns during the base period, or in appropriate cases, the earlier experience of the taxpayer, this fact should be taken as a warning that in all probability some error has entered into the calculation of constructive earnings or that some significant factor affecting net income has been overlooked or incorrectly appraised. In such case careful review of all steps in the reconstruction is required.

The rate of return on equity capital, because it measures the return to the taxpayer, is usually a proper ratio for consideration in this connection. It should be used unless the taxpayer or its industry is characterized by extraordinary variations in the proportion of borrowed capital, resulting in unusually wide variations in rates of return on equity capital. In this situation the rate of return on the total of all capital employed in the business, including borrowed capital, is a more stable and reliable indicator of earning power than the rate on equity capital alone. It is calculated by including borrowed capital in the basis, or denominator of the ratio, and the interest paid on such borrowed capital in the return, or numerator.

The rates of return which a taxpayer of changed character could be presumed to have made during the base period under normal operating conditions cannot ordinarily be directly determined by comparison with its past experience, industry experience, or that of comparable concerns, with sufficient precision to serve the purpose of reconstruction under section 722(b)(4). Ordinarily, therefore, an original determination of constructive average base period net income should not be made on this basis.

(iv) *Summary.*

It should be noted that these checks and tests do not involve merely the comparison of a detailed method with a short-cut method, nor a comparison of the taxpayer with other concerns. No single method may be described as the "comparative" method. Information derived from comparable concerns may be used either in a detailed or in a nondetailed reconstruction. Similarly, the taxpayer's experience prior to its change in character may be employed in the reconstruction. The use of such experience would be a "comparative" method based on the judgment that the prior experience of the taxpayer, properly adjusted, is representative of the experience to be attributed to the changed taxpayer. The essence of the check methods described is the test of the reasonableness of a computation, detailed or short-cut, in order to ascertain that the result is in line with pertinent experience.

(3) *Application of the push-back rule.*

In applying the push-back rule, it should be kept in mind that the ultimate objective is to find the earning level which the taxpayer would have reached by the end of its base period if it had commenced business or made the change in character two years before it did so.

Reference has previously been made to the fact that the effect of a two-year earlier experience in determining a normal earning level by the close of the base period may be measured either by reference to the last full base period year or by reference to a shorter period. It may happen that even after application of the two-year push-back rule, earnings for the last full base period year would still represent a year of partial development. Consequently, it is necessary in some cases to select a shorter period at the close of the base period which is representative of maximum normal development during the base period but which truly reflects normal operating conditions and normal earnings for the taxpayer. The last quarter of 1939, however, may be unreliable because of the effects of the European War.

Earnings are the resultant of sales volume, selling prices, and costs. If the taxpayer has had a long enough base period experience after the commencement of business or the change in character, either the last full base period year or a shorter period at the close of such year may reflect the same sales volume, selling prices, and costs (and the normal operating conditions upon which these are based) which the taxpayer would have attained with two years' earlier experience. Any or all of these three factors may not have reached the level which would have been reached with two years' earlier experience, and would thus have served to limit the actual earnings. In such case, the push-back rule will be utilized with respect to the appropriate limiting factor or factors.

In many cases, constructive sales volume, selling prices, and costs cannot be determined independently of each other. The volume of sales may be limited by the selling prices, and both in turn may be affected by the productive capacity and the costs of operations. Likewise, costs of operations may be

dependent upon sales volume, which in turn governs the amount of production. So also, the volume of sales may influence sales prices. Thus, it may be impossible to apply the push-back rule separately to each element entering into net income. Likewise, no step-by-step formula for the application of such rule can be presented.

(a) *Tests to determine whether push-back will produce a higher level of earnings.*

As has been pointed out, it is theoretically necessary to apply the push-back rule in every case in order to determine whether reconstruction is to be based on a higher level of earnings than actually existed at the end of the base period. In the case of taxpayers having an adequate experience after the section 722(b)(4) qualifying event, however, it may be possible to determine the applicability of the rule by an examination of this experience, of its consequences, and of the taxpayer's relative position in its industry. The following discussion is intended to suggest some possible approaches which may be taken in making such determination.

(i) *Examination of taxpayer's operating conditions.*

In many cases, the taxpayer will be found to be operating at or near its maximum practicable productive capacity by the close of the base period. If an examination reveals in addition that there is no excessive inventory at the close of the period, it may be concluded that both production and sales are normal and would not be increased if the taxpayer's experience had been increased two years. In such case, if the taxpayer's selling prices per unit are in line with the industry prices, and if the taxpayer's operations are carried on without any of the difficulties normally encountered by a beginning business, it may be concluded that computations under the push-back rule are unnecessary.

(ii) *Taxpayer's relative position in its industry.*

This approach is based upon a comparison of the taxpayer's operations in terms of sales volume, prices, and costs at the close of the base period with operations of mature competitors or of its industry. Thus, a determination of whether the taxpayer's utilization of its plant capacity is normal might, in some cases, be made by comparing the ratio between the taxpayer's utilization and its rated capacity with the corresponding ratio for the industry. In making such comparison, care should be taken that events or conditions which are unusual in the experience of the taxpayer or the industry are not reflected.

The actual costs and expenses as of the close of the base period should then be examined to determine whether they bear a reasonable relationship to industry costs or costs of other mature members of the industry. These costs should be examined for any unusual circumstances affecting the taxpayer which are not attributable to its initial development, e.g., excessive costs caused by strikes or higher material prices due to unusual factors. High costs caused by relative inexperience of labor or by other factors inherent in initial development indicate the need for additional experience under the push-back rule.

Similarly, the sales prices of the taxpayer at the end of the base period should be compared with the going prices in the taxpayer's industry. Correspondence of the two indicates that the taxpayer has passed its initial development period so far as sales prices are concerned. Slight differences, or even substantial differences that can be explained in terms of the price policy of the taxpayer, would not indicate a failure of these prices to be normal for the taxpayer after its development period. For instance, the taxpayer may have a

permanent policy of high volume and low unit profit rather than of high unit prices with a low volume. Likewise, any undercutting of industry prices reflecting special cost savings that are inherent in the taxpayer's operations would constitute no evidence of immaturity of the taxpayer. The only price differences which would be material would be those which can be traced to the taxpayer's initial efforts to establish a position in its industry.

Finally, examination of the inventory position of the taxpayer at the end of the base period should indicate whether sales are keeping up with production. In the absence of excessive inventory accumulation, it may be concluded that sales volume is in line with production, and therefore normal.

If an analysis of the factors described indicates conformity of the operations of the taxpayer with those of the comparable concerns or the industry, in the light of the nature and size of the taxpayer, it may be concluded that the application of the push-back rule would not produce a higher level of normal earnings. This conformity may be demonstrated if the earnings of the taxpayer are not increasing at a faster rate than those of mature members of its industry.

(iii) *Comparison with other corporations or other units commencing or changing character two years earlier.*

In some instances, it may be possible to compare the taxpayer's operations and earnings at the close of its base period with those of other members of the taxpayer's industry which had commenced business or changed the character of the business two years prior to the taxpayer's commencement or change. In the case of taxpayers which operate multiple units, the same comparison might be made with previously existing units of the taxpayer's business. Thus, in the case of a taxpayer which operated a chain of stores and which qualified for relief by adding new retail outlets throughout the base period, it may be possible to draw inferences from the history of older stores as to the normal rate of growth and the length of the normal development period for new stores. Relationships established between the taxpayer and comparatives, either within or without its own business, may indicate that the taxpayer's earnings would not be materially greater after an extended period.

(b) *Use of push-back rule where taxpayer has adequate experience and volume of production and sales are normal.*

In the case of certain taxpayers, production, selling prices, and dollar sales may have reached normal levels by the end of the base period, while costs remained excessively high due either to inherent disadvantages in internal operating conditions, or to the maladjustments which are characteristic of a beginning or changed business. As has been pointed out previously, the application of the push-back rule cannot result in the reconstruction of costs based on inherent operating conditions. The sole factor for which costs will be reconstructed in cases where volume and dollar sales have reached normal is, therefore, operational inefficiency due to development difficulties.

It is neither necessary nor practicable for purposes of this Bulletin to attempt a detailed check list of initial operating handicaps which would be expected to result in abnormally high initial production costs. The following are, however, illustrative: (1) wastage of raw material, rejects of finished goods, and allowances for substandard quality are likely to be unusually high in a new or changed business and all serve to increase the unit cost of goods sold; (2) machinery maintenance costs, which in a new plant are largely adjustment costs, may be excessive in that special or additional personnel are employed

solely to supervise shake-down operations; (3) if the new or changed taxpayer does not have an ample reservoir of skilled labor upon which to draw, the productivity of labor during the training period may be low and unit labor costs excessively high; (4) in the case of mercantile or service corporations, promotion costs including advertising expense and the outlay for temporary personnel may be excessive as compared with those of mature corporations.

Reconstruction under the push-back rule to adjust solely for excessive initial operating expense should be based, if possible, upon the experience of the taxpayer. The extent of which it has been able to solve certain of its operating difficulties may offer a clue to its probable ability to solve others. More specifically, by the end of the base period it may have diagnosed certain of its difficulties and may have devised practical means for their solution without, however, having yet put such means into effect. In the case of labor efficiency an upward trend of productivity may properly be taken to indicate a continuation of increased efficiency within the limits, however, of the efficiency of labor in similar but more mature plants.

If the experience of the taxpayer is too limited to be a useful guide, the experience of more mature competitors may in proper cases be taken as a guide to the probable experience of the taxpayer. If recourse is had to the experience of comparable concerns, however, care must be taken to isolate the operating conditions which are peculiar to the taxpayer. Thus, for example, dyeing plants often have difficulty in fixing upon the most successful treatment of their water supplies. Typically, after an initial period of trial and error, during which spoilage of goods is excessive, the proper treatment is discovered and applied. It is not possible, however, to assume that such will always be the case. A given beginning corporation in this industry might find after a period of experiment that its water supply would not respond to ordinary treatment and thus it might be compelled to seek another and possibly more costly source.

In no case, of course, may it be *assumed* that costs of the taxpayer will, after a period of two years, reach the same level as that reached by other apparently similar taxpayers after a similar period of development. Costs as between the various members of an industry vary much more widely than selling prices, and, typically, variations in profits are attributable to variations in costs. In reconstructing costs, therefore, it will always be necessary to examine into the differences in internal operating conditions among concerns. No reconstruction may be made for conditions peculiar to the taxpayer which cannot be overcome by experience.

Initial consideration of the taxpayer's experience may indicate that the taxpayer's production, costs, and sales volume are in line with those of established members of the industry, but that net selling prices measured by the same standard are abnormally low. Low net selling prices, may, of course, be evidenced not only by low list prices, but by excessive trade and special discounts, or by special allowances, "deals," or other concessions. Such a situation may indicate that with two years' added experience some increase in net selling prices might be expected. Before any upward adjustment of prices is attempted, however, the causes of such low net prices must be examined. Low net prices may, for example, be the result of a deliberate policy to seek volume at the expense of unit profit. Second, a low net price policy may be adopted as a device for concentrating competition in a region or territory in which the taxpayer has a freight advantage. Third, a taxpayer introducing a new product may decide upon a price policy adjusted to a long-time market policy, so that its profits in the first few years, perhaps even ten or fifteen years, might be

expected to be low. In none of the above cases would any upward adjustment of net selling prices be justified under the push-back rule, since in such cases selling prices could not be expected to be higher after two years of additional experience.

On the other hand, it is common for beginning or expanding taxpayers to seek to attain quick volume by temporary price concessions. In such a case upward adjustment of selling prices through the application of the push-back rule will be justified if the taxpayer can demonstrate that with two years of additional experience it would have been able to modify or abandon its initial or developmental price policy. It is obvious that any general rule for the application of the push-back to selling prices would be valueless. The extent to which a taxpayer could be expected to overcome its initial price disadvantage depends upon a variety of circumstances inherent in its own organization, in the nature of its competition, and in the peculiarities of the market. The following principles, however, should be useful.

The best indication of what course the taxpayer's price policy and practice could be expected to follow during its initial development period is its own experience. Thus, if the taxpayer had two years of experience, at the end of which its net selling prices were still out of line with its competition, the extent to which it had overcome its initial price disadvantage during such two years should, if analyzed carefully, provide a guide to what would have happened during an additional two years. For example, if the taxpayer began business by granting full trade discounts to all buyers, regardless of their status (i.e., whether retailer, wholesaler, or bulk distributor), but at the end of two years had succeeded in confining such discounts to distributors in, say, half of its selling territories, then it might be concluded that with two years' additional experience it would have been able to accomplish the same result in all its territories where competition was similar. Again, it might be observed that during the two years of actual experience the taxpayer gradually tightened its sales policy by reducing or eliminating free goods, enforcing stricter eligibility rules on cash or trade discounts, or by gradual reduction of advertising, cartage, or other similar allowances. If such changes appeared not to inhibit sales volume, and if there appeared to be no effective resistance by competitors to the establishment of the taxpayer on a basis of price equality, then it might be possible to consider that with two years' added experience the taxpayer would have been able to improve its price position in a degree consistent with its improvement during the period [of] its actual experience.

It is necessary to call attention to the fact that selling prices should in no case be increased constructively, except after consideration of the effect of such constructive increase upon the taxpayer's competitive position in its industry. For example, the taxpayer's competitors might be unwilling to meet the taxpayer's low beginning prices but might be impelled to take drastic competitive steps as the taxpayer approached maturity. On the other hand, the taxpayer, because of the superiority of its product, might be able to ignore retaliatory competitive moves and thus increase its selling prices more rapidly than would otherwise have been possible.

The considerations which have been outlined above are not, of course, susceptible of exact measurement. Nevertheless, they must be taken into account in the application of the push-back rule. The weight to be accorded to them is a matter of judgment, but such judgment should not be exercised

except after study of the taxpayer's management, policies and costs, together with the nature and history of the taxpayer's competition and the demand for its product.

(c) *Application where taxpayer has adequate experience but where all factors of volume of production, sales, selling prices, and costs must be reconstructed.*

A more difficult problem of reconstruction under the push-back rule will be encountered in the case of a taxpayer which, although it has had considerable experience in its new or changed character, appears nevertheless not to have attained a normal level of production, dollar sales, and costs. If none of the above factors is normal it follows, of course, that income will not be normal, and the extent to which earnings would be expected to increase after two additional years must be determined.

The fact that income had not reached normal by the end of the base period may be exhibited in the year-by-year progress made by the taxpayer. If no such progress is observable, there is no indication that the taxpayer was in a stage of initial *development* so that an extended period of two years would be expected to result in an improvement in earnings. It is not sufficient, however, that the taxpayer's earnings had been increasing, if they were increasing only at the same rate as comparable mature members of the industry; this would show only normal industry growth. A marked upward trend for the taxpayer as compared with mature concerns is needed to indicate developmental growth necessitating the use of the push-back rule.

Having established by the more rapid growth of its earnings that the taxpayer was in its initial developmental stage, it might appear that the most convenient technique by which to apply the push-back rule would be to (1) move back two years the net earnings of each year (through 1939) subsequent to the commencement or change in character, (2) determine the trend of these earnings, (3) extend this trend two more years, and thus observe what level of earnings would be established as of the end of the base period. This direct application of the push-back rule to earnings, however, hides many pitfalls which almost certainly preclude a reliable result.

In the first place, the performance of earnings after the change in character is too short to permit the determination of a reliable trend. The marked cyclical movements of the profits of most industries during the base period would usually distort the pattern of earnings improvement of the taxpayer. For business generally, earnings in 1938 showed a substantial fall from 1937, and 1939 showed a marked improvement. The pattern in the taxpayer's industry might be quite different from business generally, but in any event such cyclical movements would preclude the ascertainment of a reliable trend from the record of a few years. Likewise, the existence of temporary and abnormal circumstances, when reflected in the taxpayer's earnings, might conceal or distort a true trend.

Second, and even more important, in a case such as that under discussion, where the elements causing the trend are temporary developmental difficulties, there is no warrant for the extension of a past trend into the future. The extension of a trend for forecasting purposes assumes the continuance of all the factors of change which the trend reflects. In the present instance the trend represents the sum-total effect on earnings of a variety of operating conditions of the taxpayer, internal and external, while initial handicaps were being overcome. It is probable that each year certain phases of the operations of the taxpayer reached a stage of development where little further improvement would

be expected. There is no reason to expect a trend which reflects these diverse forces, operating (or ceasing to operate) at different times, to continue into the future at the same rate as in the past.

The problem of reconstruction under the push-back, then, is to identify the particular phases of the taxpayer's business in which progress was under way at the end of its base period, measure the rate of progress in each phase, and judge how much more progress would have been made in two additional years of experience under normal conditions. For example, at the end of the base period the rate of progress and the nearness to maturity may be quite different with respect to the attainment of normal sales volume than with respect to unit costs or unit sales prices.

The general operating conditions which must be reconstructed are reflected in costs, selling prices, and volume. Under each of these categories there may be several factors or phases which require study in the case of a particular taxpayer, depending on the nature and complexity of the operations.

In judging the progress to be expected in a particular phase of the taxpayer's business in two additional years, caution must be observed not to extend the apparent past trend of the phase by a mathematical formula or a straight line. This would assume that the future would continue past experience, an assumption the validity of which must always be carefully examined. For example, if a steady downward trend is evident with respect to unit costs of production, it is possible that further improvement might be expected, but it is also possible that most of the wastes incident to the developmental stage of the business have been eliminated and that the trend would flatten out in the next two years instead of continuing downward at the same rate. It is obvious that no straight-line trend can continue indefinitely. The problem therefore is to judge the timing of the turning point.

Guidance in determining when the turning point will be reached will usually be found in an analysis of the nature of the progress being made. It will usually take longer to exploit fully the potentialities of the market, that is, to get customers, than to eliminate the kinks in productive techniques and bring labor up to normal efficiency. Comparison with the experience of other concerns in the taxpayer's industry should give an indication of future expectations in the taxpayer's business. If the taxpayer has reached a position with respect to labor efficiency, for instance, closely similar to comparable concerns in its industry, it is probable that the initial development period for this aspect of the taxpayer's business has been completed, and that no further substantial improvement would be expected in two more years of experience.

(d) *Use of push-back rule where taxpayer is without adequate experience.*

The more difficult case is presented where the taxpayer's actual experience is inadequate and where all factors must be reconstructed under the push-back rule. In such instances, the two elements to be used as the starting point are the physical characteristics of the taxpayer and the nature of the market in which it operates. These will afford a basis for determining the total practicable productive capacity and the operating costs at various levels of production. In the light of these factors judgment must be made as to the selling prices at which the taxpayer would have been able to dispose of its output at various levels of production. With this as a start, the past competitive experience of the taxpayer and competitive experience of similar concerns operating under the same or similar circumstances may be used to determine the portion

of the demand which the taxpayer would have supplied had it commenced business or made the change two years prior to the actual commencement or change.

Where the taxpayer's actual base period operations furnish inadequate experience for an analysis such as that described in the preceding section, as in cases involving commencement of business late in the base period, recourse may be had to the experience of comparative concerns, preferably concerns which commenced business approximately two years before the taxpayer. If such comparatives are available, and if it is judged that the taxpayer's competitive experience under base period conditions, either in carving out a place for itself, or in replacing others, or in obtaining a portion of the demand is similar to that of the comparatives, the assumption may be made that if the taxpayer had started business or made the qualifying change two years earlier, it would have reached the same level of earnings by the end of its base period as was actually reached by the comparable concerns in the same period. Such an assumption would be warranted only after an investigation of critical factors, with respect to which the taxpayer might be at a permanent advantage or disadvantage in relation to the comparatives. These relevant factors may be freight rates, proximity to raw materials or to the market, wage rates and character of available labor, and managerial efficiency. To the extent that the taxpayer is at any such advantage or disadvantage, the push-back level of earnings should be adjusted to reflect such factors. Primary consideration should be given to the strategic factors that are determinative of the net earnings of such a taxpayer, and the result should not be out of line with the general experience of similar concerns.

In the somewhat simple case of a retail sales business it will generally be found that volume of sales and selling prices are independent of purchases and costs of operations. In the rare case it may be found that the limiting factor is the ability to purchase goods for resale. In any event, however, in this type of situation volume of sales and selling prices will generally be the starting point for reconstruction, subject to an ascertainment of the taxpayer's ability to purchase goods for resale in quantities sufficient to enable it to expand its volume.

Where, as in the cases referred to in the preceding paragraph, it is found to be proper first to reconstruct sales and selling prices, special attention should be given to any actual progress made by the taxpayer in training its sales force, advertising its products or services, and otherwise overcoming initial development difficulties. It is especially important to look for indications that will assist in judging when the "leveling off" of sales volume and prices marking the end of the initial development period will have occurred. Since the objective would be to determine what the taxpayer's volume of sales and selling prices would have been by the close of the base period on the assumption of a two-year earlier experience, actual results, adjusted for any unusual circumstances, should first be considered. Such results should then be adjusted for any differences in economic conditions existing between periods of the same length two years earlier and the periods of actual existence. This may be accomplished by establishing a ratio of industry sales and selling prices for the earlier periods to such sales and selling prices for the later periods. Such ratio may then be used to push the taxpayer's actual sales and selling prices back two years. The problem would then be to determine what its sales and selling prices would have been from that point to the close of the base period.

An example of the technique referred to above is as follows:

Period	SALES		
	Taxpayer	Comparative A Corp.	Average for mature comparable concerns
	Commenced Business July 1, 1939	Commenced Business March 1, 1937	Existing Throughout Base Period
July 1, 1937 to Dec. 31, 1937		$10,000	$16,000
1938		8,000	20,000
Jan. 1, 1939 to June 30, 1939		6,000	10,000
July 1, 1939 to Dec. 31, 1939	$12,000	15,000	20,000

The data for the mature comparable concerns show that sales of the last half of 1937 were 80 percent of sales for the last half of 1939. Based upon the sales volume reached by the taxpayer during the last six months of 1939 of $12,000 it could be reasoned that if the taxpayer had commenced business two years earlier, its sales in the last half of 1937 would have been 80 percent of $12,000 or $9,600.

The A Corporation, which started business March 1, 1937, increased its sales of $10,000 for the last half of 1937 to $15,000 for the last half of 1939, or an increase of 50 percent. It might further be reasoned that the taxpayer would have made the same increase from its assumed sales of $9,600 for the last half of 1937 to $14,400 for the last half of 1939.

Reconstruction of costs and expenses should not proceed upon the basis of applying to reconstructed sales the percentages which the taxpayer's actual costs and expenses bore to the actual sales. The reason is that some costs and expenses might be expected to vary directly in proportion to total sales, others would vary but not in such proportion, or in the case of fixed costs and expenses no variation might be expected.

The reconstruction of costs and expenses should be consistent with the reconstructed total unit sales and the total dollar sales. The effect of an increase in sales must be measured with respect to each cost and expenses account appearing on the taxpayer's books, except where the use of short-cut ratios is proper. It is necessary to study the taxpayer's classification of accounts and the nature of the transactions recorded in each account, and to consider the taxpayer's policies with respect to such transactions. For example, officers' salaries is a type of operating expense which may be regarded as semi-fixed in nature. The extent to which these salaries would have been increased had a substantial increase in sales and earnings occurred is a problem in the reconstruction of normal earnings. Salaries previously paid by the taxpayer and its policies as revealed by an analysis of this expense account and the minute book containing resolutions fixing salaries should be considered in determining to what extent salaries are dependent upon earnings. If the policy has been to increase salaries when a substantial increase in earnings occurs, a constructive increase of officers' salaries may be proper, depending upon the increase in earnings reflected in the reconstruction. Such increase should not necessarily be in the same ratio as increase in sales. Similar treatment should be accorded to other semi-fixed expenses such as advertising and general administrative expense.

If the taxpayer is in a new field of business enterprise comparable concerns will not be available. In such event the determination of the level of earnings

at the end of the extended period will require that proper consideration be given to the large elements of risk which an entrant into a new field of business activity usually encounters.

(4) *Computation of earnings for entire base period.*

Techniques of reconstructing earnings for the entire base period will depend upon the manner in which the taxpayer's normal competitive position in its industry has been established. (See Part V, Subpart II (B) (2)(c) for the discussion of the two approaches that may be taken in making this determination.)

(a) If the taxpayer's normal operating conditions are determined to have been such that the first approach is applicable, it will be necessary to make a separate reconstruction for each year of the base period similar to the one described above for the end of the base period. Normal earnings must be determined on the basis of the portion of the demand which it can be established that the taxpayer could have captured during each base period year. The taxpayer for which such reconstruction is made is the physical taxpayer as it actually or constructively existed at the close of the base period.

Under this first approach it is necessary to ascertain what effect the entrance of the taxpayer, in its changed character would have had on the competitive situation in the industry. It is not to be taken for granted that the price structure would have remained unchanged with the additional competitor. The prices the taxpayer could have charged and the volume it could have sold must be determined. Since costs and expenses usually vary at different levels of production and sales, it is necessary to determine for the taxpayer in each base period year the internal operating conditions which would be normal under the circumstances. These circumstances include, in addition to costs and expenses as related to sales volume, variations from year to year in such internal operating conditions as costs of raw materials and wages. See also the discussion in paragraph (C)(2) above with reference to the use of the experience of the taxpayer or of comparable concerns and to the use of certain ratios both for the purpose of a short-cut to a detailed reconstruction of costs and expenses and as a check upon the accuracy of a detailed reconstruction.

(b) In those cases where normal operating conditions for the taxpayer are determined to have been such that the use of the second approach is proper, two general techniques of reconstruction for the entire base period are available. In these cases, the portion of the demand existing throughout the base period which the taxpayer should be considered as having supplied will be based upon that portion which the taxpayer supplied actually or constructively, as of the close of the base period.

(i) The first technique, which may be regarded as a short-cut for the second, would ignore a separate and detailed reconstruction of sales, costs, and expenses for the portion of the base period prior to the period for which it is determined that the taxpayer had actually or constructively reached the earning level it would have reached with a two-year earlier experience. Since this earning level may have been determined with reference to a shorter period than the last full base period year, it is necessary in such cases to place the earnings for such short period on a yearly basis. If seasonal variations or other factors make a straight annualization an improper method of

reflecting normal earnings for the entire year, figures of other comparable members of the taxpayer's industry could be used to establish a relationship between earnings for the short period and earnings for the entire year. This ratio would then be applied to the earnings for the short period in order to place such earnings on a yearly basis.

Having arrived at normal earnings for the last year of the base period, the first technique would require only that a relationship be established between earnings for that year and earnings for the earlier years of the base period. The need for the application of this ratio in reconstructing earnings for the entire base period arises from the fact that business conditions in the taxpayer's industry during the last base period year may have been better or worse than average base period conditions for that industry.

To applv this technique, an index of earnings may first be conconstructed for the entire base period using the last year of such period as 100 percent, based either upon the earnings for each year of other representative activities of the taxpayer or of representative members of the taxpayer's industry. If, during the base period, there have been important changes in the industry in the number of concerns, capital investment, or net worth, the earnings on which the index is based should be expressed as ratios to some such factor as net worth in order to make the index representative of the experience of a single concern with no important changes in capital.

If there are no figures available for the industry or for comparable concerns, the most general business profits index, i.e., the earnings of all corporations, might be used. However, if the taxpayer's business is of a local character, or if the products or services sold have a particular geographical distribution, the general business index might be localized to fit the taxpayer through the use of some local index of business profits.

If the taxpayer is a member of an industry which is in its initial development stage during the base period, use of the industry index may not be appropriate. The presence of development means that the index contains initial growth elements in addition to normal fluctuations. In such cases, indexes of similar industries or the general business profits index might serve as the instrument by which the 1939 position of the taxpayer could be adjusted to average base period conditions.

After obtaining this index for each base period year (1939 being 100), it is applied to the reconstructed earnings for the last year of the base period; that is, the last year reconstructed earnings are multiplied, successively, by the indexes for the other years, and the result divided by 100 (since the index is a percentage). The result is reconstructed earnings for each year of the base period.

The assumption made by the use of the technique described above is that the relationship between the taxpayer and the comparatives with respect to operating conditions, including volume of production and sales, is fairly constant throughout the base period. The same assumption is made with respect to the taxpayer's competitive position.

These assumptions will be entirely unrealistic in many cases where, despite general similarity, certain phases of the taxpayer's business are peculiar to it. For example, assume that a taxpayer's business is conducted in leased premises and its annual rental is considerably higher than similar fixed charges for other members of its industry. In such a case the relationship of earnings between base period years for other members of the industry or for general business might not be representative of the relationship that would have existed for the taxpayer. Profits for the taxpayer would be dependent on a certain volume of sales in order to meet its higher fixed charges. If the portion of the demand which the taxpayer supplied as of the close of the base period yields a volume of sales insufficient to show a net profit for one or more of the base period years due to the existence of the fixed charges, the resulting net loss would be representative of normal operations for the taxpayer. In such a case the use of the first technique might result in a net profit for the taxpayer in that year, since the index based upon earnings of other members of the industry or of general business would reflect a profit for that year. This result would be inconsistent with the normal operating conditions of the taxpayer. This technique should not, therefore, be employed in any case in which the assumptions referred to are not valid.

(ii) Under the second technique it would first be necessary to reconstruct sales for each base period year. Thus, the portion of the demand which is deemed to be supplied by the taxpayer in each base period year will be the same actual or constructive portion which the taxpayer secured at the close of the base period.

The sales of the taxpayer for each base period year will be obtained by the use of an index of industry sales based upon 100 percent for 1939, as in the method described above for industry earnings. Likewise, internal operating conditions as they existed, actually or constructively, at the close of the base period, are to be considered as characteristic of the taxpayer throughout the base period. Costs and expenses should, however, be reconstructed on the basis of the variations that would be expected for these items as a result of varying levels of production and sales. Reconstruction of these items should also take into account variations from one year to another in such factors as prices of raw materials and wage rates.

The reconstruction may be made in the same manner for the balance of the base period as is suggested in paragraph (C)(3) above for the close of the base period. See also the discussion in paragraph (C)(2) above with reference to the use of the experience of the taxpayer or of comparable concerns and to the use of certain ratios both for the purpose of a short-cut to a detailed reconstruction and as a check upon the accuracy of a detailed reconstruction.

(D) Reconstruction methods with reference to specific changes.

(1) *Difference in ratio of nonborrowed capital to total capital.*

The taxpayer's actual experience will be sufficient for purposes of reconstruction in these cases. The only information necessary is the average equity invested capital and the average borrowed capital during each base period year

and at December 31, 1939, and the interest paid or accrued in each base period year. See Subpart I, paragraph (C)(4) for detailed discussion of reconstruction.

(2) *Change in the operation of the business.*

Changes of this kind will ordinarily involve only a difference in costs of operation. In some cases, there may be a concurrent change in selling price, which in turn may cause a change in volume of sales. In any case, since a change in operation is not subject to the commitment rule, the taxpayer will have had some actual experience with operations after the change and prior to January 1, 1940.

If the change in operation resulted only in a difference in costs, the taxpayer's actual experience both before and after the change should be analyzed in detail to determine the effect of the change. Such analysis should be made wherever possible on a monthly basis, or at least on a quarterly basis, and, where appropriate, should include volume of production and unit costs. From this information it should be possible to determine what changes in costs occurred as a result of the qualifying change in operation and whether the push-back rule is applicable. If the full benefits of the change in cost have been realized by the end of the base period, the reconstruction can be made by assuming the change to have been in existence throughout the entire base period and adjusting costs accordingly. In some instances this may be done by adjusting each account affected by the change. In other cases, it may not be desirable to compute the change in each account or to compute the cost savings on a unit basis. In these instances, the savings in cost after the change may be expressed as a percentage of sales and applied on the same basis to sales for the entire base period.

If the push-back rule is applicable, reconstruction of costs for the entire base period may be made on the basis of costs thereby determined. If only a difference in costs is involved, the push-back rule is applied in accordance with the principles discussed under the heading "Internal operating conditions". To illustrate, assume that the taxpayer operated five machines during the base period and in October, 1939, replaced one of the machines wtih a new one having the same capacity but requiring fewer man-hours of labor in its operation. If it is shown that savings in cost were not fully realized by the end of the base period because of insufficient training and experience of employees, the cost savings may be computed on the basis of an assumed installation of the machine two years earlier. The push-back rule may not be applied to obtain the cost savings on the entire five machines on the erroneous theory that, had the one machine been installed two years earlier, all five would have been replaced by the end of the base period. Such use of the push-back rule would recognize a change in operation which was not actually made during the base period.

It can never be assumed that savings in costs necessarily result in an equivalent increase in earnings. Such savings are frequently accompanied by a reduction in selling price. This is particularly true in a competitive industry where the change in operation is gradually being made by all members of the industry. In such case the actual change in margin of profit, rather than in cost, must be determined and reconstruction made on that basis. Such an adjustment may be necessary even though no change in selling price has occurred during the base period. If competitors are making or will make similar changes in operations, the taxpayer may have only a temporary advantage on which normal earnings cannot be predicated.

If it is claimed that an increased volume of sales would have resulted from a reduction in selling price, the normal operating conditions should be determined in accordance with the principles discussed under the heading "Taxpayer's competitive position".

The taxpayer's actual experience is generally the best source of information for use in reconstructing for a change in operation of the business and is to be preferred to the use of the experience of comparable concerns. The use of comparatives should usually be limited to those cases in which the change was made late in the base period, and the taxpayer's actual experience has not been sufficiently extensive to measure the results of the change.

(3) *Change in capacity for production or operation.*

(a) *During the base period.*

If the change in capacity was consummated prior to January 1, 1940, a detailed analysis should be made of the capacity before and after the change and the extent of its utilization. Thus, the first step in reconstruction in such cases is to determine from the taxpayer's actual experience the extent to which the change influenced its earnings. If it is determined that the push-back rule is not applicable, and that its competitive position had been established by the end of the base period, reconstruction might be made on the basis of such position for the entire base period.//

To illustrate by a simple case, assume that a taxpayer, operating a chain of retail stores, opened a new store of the same character in May 1938 in a territory not previously served by the taxpayer. The new store had no effect upon the existing stores which were continued in operation, and its addition is found to qualify as an increase in capacity. Depending upon relationships between the operating conditions of the new and old stores, sales and costs, or net profits of the new store might be determined by reference to the sales or costs or the net profits of the old stores. Thus, a comparison of monthly sales of the new store with the sales of the old stores might show that the new increased steadily until July 1939 when they "leveled off" at approximately 20 percent of the old. Sales for the new store might be reconstructed on the basis of 20 percent of sales of the old stores for each year of the base period. If it is found that, due to local conditions in the new territory, sales of the new store fluctuate differently from those of the old stores, the normal level of sales at the end of the base period might be determined by establishing a relationship to comparable mature concerns in the same territory. When the relationship remains fairly constant from month to month, it may be assumed that the new store has reached its normal sales level. Reconstruction of sales might then be made upon the basis of this relationship.

In either event considered in the example, the taxpayer's actual percentage of gross or net profit to sales, established after its sales had reached a normal level during the base period, should be used as a basis for the gross or net profit reconstruction. It should not be assumed that this percentage would remain constant throughout the base period. Adjustment should be made to reflect the changes in economic conditions. This might be accomplished through the use of ratios between the percentage found and the profit percentages realized in each of the base period years by the taxpayer's old stores or by the applicable comparable concerns.

If it is determined that the push-back rule is applicable, normal operating conditions by the end of the base period must be determined in accordance

with the principles discussed at (B)(2) above. The reconstruction should be made in accordance with the principles discussed at (C)(3) and (4) above.

(b) *Commitment cases.*

The problems arising in this type of case stem from the fact that the additional capacity for which constructed earnings are sought was not acquired prior to January 1, 1940, and no actual experience is therefore available prior to that date to furnish a basis for such computations.

In the majority of cases it will be necessary to apply the push-back rule and to assume that the changed capacity had existed on December 31, 1937 in order to determine the normal earning level to be used in reconstruction.//

These cases will generally fall into two classes. The first class includes those where the added capacity is utilized to increase the volume of the product or products actually manufactured or sold prior to January 1, 1940, or to begin production or sale of products new to the taxpayer but which have a relatively stable demand. The second class includes those where the capacity is added to manufacture or sell products which were not sold during the base period.

In the first type of case, the application of the push-back rule and the reconstruction on the basis of the determined normal earning level might be made as in the case of a change of capacity actually made in the base period since there generally will be data available, either within the taxpayer's experience or within the industry, to provide a basis for determination as to the demand and the internal operating conditions.

For example, assume that a taxpayer operated an established business throughout the base period using 50 factory units. Assume further that in August 1939 a contract was entered into for the installation of 25 additional units which required manufacture and were not installed until July 1940. A consideration of the operating technique should disclose the effect on total plant capacity of the added units. The new units should not be assumed to increase capacity by 50 percent, since some essential operation may limit output. The extent to which the added production could have been sold, in 1938 and 1939 in applying the push-back rule, and during the entire base period in making the reconstruction, might be determined by reference to the taxpayer's sales policies in relation to the demand for the product and the general market conditions existing with respect to the industry. Costs of the product and expenses should be determined by consideration of the internal operating conditions and the effect thereon of the added production.

If the additional units were installed to produce an item or items not previously manufactured by the taxpayer but which had been produced and sold by others, reference to data for the industry, the experience of other concerns, and consideration of the effect of the taxpayer's entrance into the field would be necessary.

The second type of case presents a more difficult task of reconstruction since no experience or data will be available relative to the effect of conditions prior to January 1, 1940, on the production or sale of the product. It will be necessary to approach the problem from the point of view of the management when the decision was made to enter into the commitment. This might be accomplished by determination of the nature and size of the expanded plant, including the number of units of product which the committed-for-capacity would normally yield; the volume of sales that would have been possible in the light of the taxpayer's established sales and advertising policies; the prices at which the product could be sold; and the costs of manufacture in the light

of the determined volume. General business conditions and industry data as they would affect the production or sale of the product during 1938 and 1939 in the application of the push-back rule and for the entire base period in the reconstruction should, of course, be given full recognition.

It has been previously emphasized in this Bulletin that the push-back rule may not be utilized to create qualifying factors which had not actually occurred prior to January 1, 1940. Accordingly, care must be taken to ascertain that in the application of the push-back rule the determined normal level of earnings reflects only the effects of the committed-for-capacity.

Since there will be a period subsequent to December 31, 1939 when the capacity for which a commitment was made was not in existence or had not actually reached full normal operations, it will be necessary in most cases to limit the level of earnings upon which reconstruction is based. Reference may be made to paragraph (F)(3) for a discussion of the application of the variable credit rule to commitment cases.

An adjustment may also be necessary because of capital additions after the commitment. A discussion of this factor will be found at paragraph (E).

(4) *Acquisition of competitor's assets.*

The treatment of the acquisition situation in reconstruction will depend upon the character of the acquisition and the circumstances which attend it. The acquisition of the assets of the competitor may have resulted in an increase in capacity for production or operation without eliminating or substantially reducing the competition of the competitor; it may have eliminated or substantially reduced such competition without effecting any change in the taxpayer's capacity for production or operation; or it may have both eliminated or reduced the competition and increased the taxpayer's capacity.

In the event the taxpayer, through the acquisition of the assets of its competitor, has increased its capacity for production or operation without eliminating or substantially reducing the competition, reconstruction will be based upon the change in capacity and not upon the acquisition of assets. The reconstruction will accordingly proceed in the same manner and under the same principles as reconstruction based upon changes in capacity.

In the event the acquisition of the assets eliminates or substantially reduces competition without effecting a change in the taxpayer's capacity for production or operation, the reconstruction should reflect only the increase in earnings which results from the elimination or diminution of the competition. In such event the prior earnings history of the taxpayer or the former owner will not be relevant, since it stemmed from a competitive situation which no longer exists, and since normal earnings of the taxpayer are to be determined upon the basis of the new situation. In general, if the taxpayer has had sufficient base period experience in its new competitive status, it may be possible to reconstruct normal earnings by reference to such experience under the methods and techniques of reconstruction described above. If the actual base period experience is not long enough for a determination of the taxpayer's new normal operating conditions, it will be necessary to reconstruct by reference to the experience of comparable concerns operating under base period conditions in the same competitive status as that of the taxpayer after the acquisition of the competitor's assets.

Finally, the acquisition of the assets may result in both an increase in the taxpayer's capacity for production or operation and the elimination or

substantial reduction of competition. In such cases the reconstruction should reflect both the effects of the removal of the competition and the increased earnings attributable to the increase in capacity.

(5) *Difference in the products or services furnished.*

If the different product or service furnished by the taxpayer is in addition to products or services already being furnished, and if the new product required new capacity for production or operation, it will be most practicable to reconstruct income as though it relied upon increased capacity as its qualification for relief.

There remain, however, three main situations in which a difference in products or services furnished requires special consideration in reconstruction. These situations are the following:

(a) The taxpayer, without changing its capacity, substitutes in whole or in part a new product or service for one previously furnished.

(b) The taxpayer, without increasing its capacity, furnishes a new product or service in addition to those already furnished.

(c) The taxpayer furnishes an additional product or service, utilizing new capacity as well as existing unused capacity.

In the first case, i.e., where the taxpayer simply substitutes one product or service for another, the objective is to substitute for the earnings of the old product the higher level of earnings attributable to the new. If the taxpayer had any considerable experience with the new product, having shifted to it say at the beginning of 1937, the actual unit profit at the end of the base period may be normal for that time, and margins for the whole base period may be reconstructed on this basis in the light of competitive and general business conditions during the entire base period. Even if the change was made late in the base period so that the new product is being produced and sold under conditions of initial development, the actual experience of the taxpayer may serve as a basis for reconstruction. That is, if costs are high for the reason that mechanical "bugs" have not been eliminated from the productive process, the actual costs at the end of the base period may be adjusted for this fact in the light of the known physical and mechanical set-up of the plant. Inherent deficiencies in the plant, for which no adjustment can of course be made, will be somewhat more easy to identify than in the case of a taxpayer with no prior experience of any kind.

Selling prices of the taxpayer under discussion may likewise be less at the end of the base period than they would have been had the taxpayer had a longer period in which to develop its distribution. Here again, however, the prior experience of the taxpayer may furnish a guide. The general prior policy of the taxpayer's management, particularly with respect to its emphasis upon volume at the expense of unit profits or vice versa, may, in the absence of contrary evidence, be expected to carry over to the changed product or service.

Determination of sales volume must be based upon the same theoretical considerations which apply to a beginning taxpayer. That is, the demand for the new product and the taxpayer's competitive position must be determined. However, the taxpayer shifting to a different product may have a certain advantage over a beginning taxpayer, as where it has an established marketing system. This would be particularly important in case the new product was related to the old and was marketed through the same outlets.

The second situation, in which the taxpayer adds a product or service without replacing the old and without increasing capacity, calls for the same reconstruction technique as has just been outlined. This situation differs chiefly from the first, however, in that no existing profits need be eliminated since no existing product is displaced.

The third situation presupposes that the existing capacity is suited to the new product and that new capacity is also installed or committed for in the base period. The reconstruction is made as in the second situation except that account must be taken of the new capacity.

Three additional observations may be made with respect to a case involving difference in products or services furnished. First, under no circumstances may volume be reconstructed except within the limitations of capacity in existence or committed for by December 31, 1939. Second, since a change-over to a different product may in some cases be made with great facility, it must be determined whether such change, particularly if made late in the base period, was directly or indirectly occasioned by abnormal events. Third, reconstruction for a difference in products or services furnished is subject to all the limitations already set out for reconstruction under section 722(b)(4) except that in a proper case unused capacity may serve as a basis for reconstructed volume.

(6) *Change in management.*

An analysis of a qualifying change in management will usually show that the changes in basic policies of the business have resulted in one or more of the changes in character listed above. Thus, the new management may have changed the methods of operation of the business; or it may have increased the capacity or changed the products or services furnished. If the change in management has resulted solely in one or more of these changes, the problem of reconstruction is the same as in the various categories discussed above. Frequently, a drastic revision in management policies will have resulted in several such changes and the principles discussed in Part VII (A), "Multiple Bases for Relief", will be applicable.

Two other changes in the taxpayer's normal operating conditions, either in conjunction with other changes or standing alone, may have resulted from a change in management. The new management may have made drastic changes which result in substantial savings in costs, as for example, where a reduction in personnel is made. Secondly, it may have initiated policies which can be shown to have improved its competitive position and made possible an enlarged volume of sales. The increased volume may or may not have been accompanied by a change in selling price. In either event, since the change in management policies must have been placed in operation during the base period, the taxpayer's own experience after the change may be the best source of information to be used in reconstruction. Reference to the experience of comparable concerns will seldom be required except in those instances in which the new management has previously demonstrated the results of its policies with some other corporation or similar policies have been adopted by other concerns in the industry.

No peculiar problems in application of the push-back or in reconstruction for the entire base period are anticipated in cases falling within this category. The most difficult problems will relate to the identification of the changed policies and the various changes in operating conditions flowing from such policies.

(E) Adjustment for capital additions after commitment.

Regulations.—Section 35.722-3(d).

(1) *Need for adjustment.*

Section 35.722-2(c) of Regulations 112 provides that the amount of the excess profits credit based on a constructive average base period net income shall be computed in accordance with section 713(a)(1) of the Internal Revenue Code, relating to the computation of the amount of the excess profits credit based on income, as follows:

(a) 95 percent of the constructive average base period net income;

(b) plus 8 percent of the net capital addition defined in section 713(g) and section 743; or

(c) minus 6 percent of the net capital reduction defined in section 713(g) and section 743.

In a commitment case unless an adjustment were made to the CABPNI [1] based upon capital additions there would be a double benefit in the excess profits credit. This double benefit would result to the extent that the additions to capital in the excess profits tax taxable years were used in the consummation of the commitment. For example, assume that a taxpayer entered into a commitment in the latter part of the year 1939 to purchase additional machinery costing $150,000. The machinery was paid for by a deposit of $50,000 in 1939 and from proceeds received from the sale of capital stock on April 1, 1940, at which time the machinery was put into operation. Without an appropriate adjustment, this taxpayer would receive a duplication of $6,000 (8% of $100,000 for ¾ year) in its excess profits credit for 1940, for the reason that its constructive average base period net income already includes income attributable to the operation of the new machinery.

(2) *Computation of adjustment.*

In order to eliminate this duplication in the excess profits credit based on a constructive average base period net income, the regulations provide the following rule:

> "* * * in computing the constructive average base period net income attributable to the change in the character of the business described in the last sentence of section 722(b)(4), the fair and just amount representing normal earnings determined without regard to the provisions of this paragraph to be used in the computation of the excess profits tax for a taxable year shall be reduced by an amount equal to 8 percent of that portion of net capital addition for such year which has been utilized in constructing or acquiring the facilities giving rise to such change. * * *"

In the application of this rule, the portion of the net capital addition in the excess profits tax taxable year which is used in the consummation of the commitment is considered to be the amount resulting from the following computation:

$$\frac{\text{Portion of daily capital additions used to effectuate commitment}}{\text{Aggregate daily capital additions}} \times \text{Net capital addition} \times 8\%$$

Not all capital additions during the excess profits tax taxable years may have been utilized to effectuate the commitment. Where the facilities acquired or constructed as a result of the commitment were so extensive as to require

[1] Constructive average base period net income.

special financing, the amount of the capital additions used for this purpose will be apparent. However, in many instances it will not be apparent and must be established by the facts in the particular case, possibly by reference to the minutes authorizing the change, to amendments of the charter where the financing required an increase in the authorized capital, or to reports filed with the Securities and Exchange Commission.

The adjustment required by the regulations is a reduction in the amount of the constructive average base period net income attributable to the increase in capacity actually reached under the commitment, limited to the amount of such constructive average base period net income. It is *not* an adjustment to the net capital addition which must still be made exactly in accordance with section 713(g) or section 743.

The adjustments to the excess profits credit on account of capital changes under section 713(g) relate to additions or reductions in capital from the beginning of the first excess profits tax taxable year. Therefore, the reduction in the amount of the constructive average base period net income attributable to a commitment should be made for each excess profits tax taxable year in which the excess profits credit is based on a constructive average base period net income which is attributable in whole or in part to a commitment. However, no adjustment is authorized where the capital change results in, or after it becomes, a net capital reduction even though the aggregate of the daily capital additions includes amounts used to effectuate the commitment.

The principles of the adjustment for capital additions after commitments may be illustrated as follows with respect to four taxpayers:

Item		Example #1	Example #2	Example #3	Example #4
	I Facts				
	Constructive Average Base Period Net Income				
(1)	Attributable to a change in capacity reached under a commitment	None	$ 10,000	$ 75,000	$ 75,000
(2)	Attributable to other factors	$275,000	265,000	200,000	200,000
(3)	Total	$275,000	$275,000	$275,000	$275,000
	Net Capital Addition or Reduction				
(4)	Aggregate daily capital additions	$600,000	$600,000	$600,000	$600,000
(5)	Aggregate daily capital reductions	200,000	200,000	200,000	700,000
(6)	Net capital addition or (reduction)	$400,000	$400,000	$400,000	($100,000)
(7)	Portion of daily capital additions used to effectuate commitment	$480,000	$480,000	$480,000	$480,000
(8)	Total cost of change in capacity under commitment	$500,000	$500,000	$500,000	$500,000
	II Solution				
(9)	*Amount of Adjustment*				
	Item (7) ÷ Item (4) × Item (6) × 8% (limited to Item (1))	None	$ 10,000	$ 25,600	Not applicable

Item		Example #1	Example #2	Example #3	Example #4
(10)	*Excess Profits Credit*				
	Constructive average base period net income—Item (3)	$275,000	$275,000	$275,000	$275,000
	Less: Adjustment—Item (9)	None	10,000	25,600	None
	Constructive average base period net income (adjusted)	$275,000	$265,000	$249,400	$275,000
	95 percent of adjusted constructive average base period net income	$261,250	$251,750	$236,930	$261,250
	Add: Net capital addition—8% of (6)	32,000	32,000	32,000	—
	Deduct: Net capital reduction—6% of (6)	—	—	—	6,000
	Excess profits credit	$293,250	$283,750	$268,930	$255,250

(F) Variable credit rule.

Regulations.—Section 35.722-3(d).

(1) *Need for the rule.*

The preceding discussion has been limited to those cases in which the constructive average base period net income to be used as a standard for the new or changed business under section 722(b)(4) is based on the full level of normal earning capacity. If the business which has been commenced or changed has reached its full level of normal operations during the excess profits tax taxable years, the standard so obtained is a fair measure of normal profits. However, there are instances in which the business may not have reached its full level of normal operations during the excess profits tax taxable years. In such situations it would obviously be unfair to allow the use of a "yardstick," based on full level of normal operations, for the measurement of earnings based on operations which have not reached that level. The regulations provide in such cases for the determination of a fair and just amount representing normal earnings which amount may vary in different excess profits tax taxable years. The following paragraphs describe the situations in which this determination is necessary.

(2) *Cases involving the two-year push-back rule.*

Reference has already been made in this part of the Bulletin to the use of the two-year push-back rule in the determination of constructive average base period net income. The use of this rule may result in construction of normal earnings based on an operating level which is higher than the level actually reached at the end of the base period and higher than the level which would be reached under normal conditions during the first and second excess profits tax taxable years. For example, assume that the taxpayer commenced business January 1, 1938 and that it had not reached by the end of the base period the earning level it would have reached had it started on January 1, 1936. Its actual earnings for 1938 were $30,000 and for 1939, $65,000. It is determined that, had it commenced business two years earlier, it would have attained an earning level of $95,000 by the end of the base period. However, as of the end of the base period it could reasonably have expected to reach an earning level of only $75,000 during 1940 and $85,000 during 1941. If an average base period net income is constructed for the entire base period based on an earning level of $95,000, such earning level would be greater than that which normally would have been reached during 1940 and 1941.

The regulations provide in this situation that "the fair and just amount representing normal earnings should be based upon the actual earning capacity which, as of the end of its base period, the taxpayer could reasonably have expected to reach under normal conditions during such first or second excess profits tax taxable year". Thus, in the above example, a different constructive average base period net income must be computed for each of the years 1940, 1941 and 1942; for 1940 based on an earning level of $75,000, for 1941 based on $85,000, and for 1942 based on $95,000.

It should be emphasized that the earning capacity which the taxpayer could reasonably have expected to reach under normal conditions during its first and second excess profits tax taxable years is not necessarily the same as that which it would have reached in the last two base period years had it commenced business or changed the character of its business two years earlier. This is for the reason that the two-year push-back rule is applied under the conditions existing during the base period, while the variable credit rule is applied under the normal conditions forecast on December 31, 1939, for the next two excess profits tax taxable years.

It should be noted that the actual earning level reached and the actual operating conditions present during the first and second excess profits tax taxable year are not to be used. The last sentence of section 722(a) provides that no regard shall be had to events or conditions occurring or existing after December 31, 1939 in determining the constructive average base period net income. Again, if the conditions after December 31, 1939 are such that the actual earnings during the first or second excess profits tax taxable years are in excess of the normal earnings reasonably anticipated as of the end of the base period, the taxpayer has realized excess profits which should be taxed. Conversely, if adverse post-1939 conditions have prevented the taxpayer from reaching the level of normal earnings reasonably anticipated, it is entitled to an unused excess profits credit.

(3) *Cases involving the commitment rule.*

A similar situation arises in connection with the application of the commitment rule. (Acquisitions of assets after December 31, 1939 of newspaper competitors in accordance with the last sentence of section 722(b)(4) will be subject to the same rule as is described in this discussion.) As explained in preceding sections of this Bulletin, under the commitment rule a change in capacity for production or operation which is consummated after December 31, 1939, is deemed to be a change on December 31, 1939. Upon application of the push-back rule, the change is deemed to have been made on December 31, 1937 and the earning level that would have been reached at the end of the base period is determined and used as the basis for the computation of the constructive average base period net income. However, during an excess profits tax taxable year, the change in capacity may not be reflected at all in the operations. Or, the change in capacity may have been only partially utilized during the year. Or, while the new capacity may have been fully utilized, normal earnings may not have been reached due to operational difficulties resulting from the lack of experience with the new facilities. In all these situations, the full level of normal earnings based upon full normal operating capacity may exceed the level of earnings which would have been reached under normal conditions during an excess profits tax taxable year, and a variable constructive average base period net income must be computed. The problem involved is similar to that under the push-back rule with two important exceptions:

(a) Under the push-back rule where no commitment is involved, not more than two excess profits tax taxable years will require the variable computation. Under the commitment rule, additional excess profits tax taxable years may be involved. To illustrate, assume that the taxpayer was committed to a change in capacity on December 31, 1939. The increased capacity did not enter into production at all during 1940. It was partially utilized during 1941 and fully utilized during 1942, but the full level of normal earnings could have been reached only by the end of 1943 after the new capacity had been operated at full normal level for two years. In such case, a constructive average base period net income, less than that based on the full normal level, must be computed for use in each of the years 1940, 1941, 1942, and 1943.

(b) Under either the push-back rule or the commitment rule, the variable constructive average base period net income must be based upon normal operating conditions. In determining these conditions under the push-back rule, no regard may be had to actual conditions existing during the excess profits tax taxable years. Instead, normal conditions which could reasonably have been forecast at December 31, 1939 are used. In determining normal operating conditions under the commitment rule, regard must be had to the changed capacity actually consummated during the taxable years, and to the extent to which this change would have normally entered into the operations during these years.

There are two methods which may be suggested for computing the constructive average base period net income in cases in which the factors discussed above must be taken into account. One method is to compute the constructive average base period net income based on the level of earnings reached under full normal capacity, and reduce this amount to the percentage of capacity actually reflected in the business during the excess profits tax taxable year. For example, assume that the constructive average base period net income based on full normal capacity of 50,000 units was $100,000. During 1940 an average capacity for only 20,000 units was utilized. Constructive average base period net income for 1940 under this method would be 2/5ths or 40 percent of $100,000. This method is acceptable only where the rate of profit per unit is not materially altered by a lower scale of operation.

The second method takes into account the different direct costs and overhead resulting from the lower scale of production. Under this method, a separate computation is made for each year depending upon the rate of production. This method is more accurate and should be used when a material difference will result.

Under either the push-back rule or the commitment rule, the variable constructive average base period net income is computed separately for each excess profits tax taxable year in which the full level of normal operations or earning capacity has not been reached. Ordinarily, once this level has been reached, the constructive average base period net income, determined on the basis of full level, remains constant and is not affected by events or conditions in a subsequent excess profits tax taxable year. To illustrate, assume that the taxpayer increased its capacity during the base period for the manufacture of refrigerators. Its constructive average base period net income based on the changed capacity was established for 1940 and 1941. During 1942 it converted its plant to the manufacture of war material. A temporary conversion to war production does not require a change in the taxpayer's standard of normal earnings and does not bar it from relief for 1942. Any profits from war con-

tracts should be measured in the light of what would have been normal profits from the capacity it had as of the end of the base period. A similar case is one in which a corporation began to manufacture a new product during the base period but was forced temporarily to abandon its manufacture in 1942 due to the scarcity of raw material. It would be entitled to the constructive average base period net income established for the changed business, even though it was manufacturing an entirely different product during the excess profits tax taxable year.

(4) *Cases involving an abandonment of a change in the character of the business.*

An entirely different situation arises where the taxpayer abandons the change which gave rise to the claim for relief. This abandonment may occur with respect to any of the changes in the character of the business included within section 722(b)(4). In the case of a change based upon the acquisition of facilities, abandonment will be deemed to have occurred if the taxpayer disposes of the new facilities without replacing them with other assets which produce income for excess profits tax purposes. In all these instances, the taxpayer will be considered to have reverted to its former character and the conditions which warranted relief in earlier years will no longer exist.

It should be remembered that the taxpayer is required to establish its right to relief for each excess profits tax taxable year. Its relief is based upon "a comparison of normal earnings and earnings during an excess profits tax period." Implicit in this comparison is the idea that the normal operating conditions, upon which relief is based, and the operating conditions during the excess profits tax period must be comparable. If in some excess profits tax taxable year the taxpayer has reverted to its earlier character, normal operating conditions for it must be based on that earlier character. Its actual average base period net income would therefore not be an inadequate standard of normal earnings for that year, and it would not be entitled to relief.

To illustrate, assume that the taxpayer operated one mill during the base period until January 1, 1938 when it purchased a second mill, thereby doubling its capacity. For 1940 and 1941 it establishes a constructive average base period net income based on its increased capacity. On December 31, 1941 it sells the second mill, distributing the proceeds of sale as a taxable dividend to its stockholders. Its normal operating conditions have reverted to the character existing prior to the acquisition of the second mill. The taxpayer is therefore no longer entitled to relief for 1942 under the provisions of section 722(b)(4).

The failure of the taxpayer to qualify for relief is based upon its inability to establish the inadequacy of base period income as a standard of normal earnings. The establishment of such an inadequacy is a prerequisite to the right of a taxpayer to a reconstruction of such base period income. Accordingly, the prohibition contained in section 722(a) against regarding post-1939 events in the course of the actual reconstruction of base period income is not involved.

In cases which do not involve abandonment or disposition of assets, war induced changes in operations, production, or management are not to be construed as the abandonment of the character of the business which has been previously established and on the basis of which relief was allowed.

The principles discussed under this heading have no application to cases arising under section 722(b)(1), (2), or (3). In the section 722(b)(1) and (2)

cases, the repetition during the excess profits tax taxable year of the abnormal event or circumstance, the occurrence of which during the base period was the reason for relief, will not affect the constructive average base period net income to be used for such year. The determination of whether the taxpayer is entitled to relief and the amount of the constructive average base period net income will take into consideration the abnormality of the event or circumstances which occurred during the base period, including the frequency of its occurrence. If an event or circumstance is determined to be unusual and peculiar so that relief is necessitated, the fact that a similar abnormal event or circumstance exists during an excess profits tax taxable year does not make the previous event or circumstance any less unusual, nor does it have the effect of changing the normal operating conditions for the taxable year. In the section 722(b)(3)(A) case there is no change in the business of the taxpayer that might give rise to abandonment. The continuation into an excess profits tax taxable year of a cyclical depression will not affect the credit for that year based upon a constructive average base period net income determined under section 722(b)(3)(A) because any unused credit for such year should be balanced against higher earnings in a later year when the business cycle, in the absence of abnormal conditions, would have carried the taxpayer's earnings above their average level. The credit is determined for *all* excess profits tax taxable years based on normal income. Similar considerations lead to the same conclusion for cases under section 722(b)(3)(B).

Part VI

OTHER FACTORS AFFECTING THE BUSINESS AND RESULTING IN AN INADEQUATE STANDARD OF NORMAL EARNINGS

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Law.—Section 722(b)(5).

Regulations.—Section 35.722-3(e).

(A) General rule.

In order for a taxpayer to obtain relief through the provisions of section 722(b)(5) it must be entitled to use the excess profits credit based on income and it must establish—

(1) That some factor, other than those enumerated in section 722(b)(1), (2), (3) or (4), affected its business; and

(2) That *because* of such factor its actual average base period net income is an inadequate standard of normal earnings; and

(3) That relief would not be inconsistent with the principles underlying subsection (b) of section 722 and with the conditions and limitations enumerated in that subsection; and

(4) The fair and just amount representing normal earnings to be used as a constructive average base period net income.

This section was intended by Congress to afford relief in meritorious cases in which the inadequacy in the taxpayer's income was caused by some factor other than those elsewhere enumerated. The coverage of section 722(b)(1), (2), (3), and (4) is so broad in the types and kinds of factors given consideration thereunder that only rarely will a factor be found which caused a clear inadequacy in base period net income and which does not come within the scope of one of those paragraphs.

Section 722(b)(5) has been interpreted by some taxpayers as being a universal "catch-all" provision. They assume that if they cannot qualify under any other paragraph of section 722(b), then section 722(b)(5) must necessarily apply. This assumption is not valid. Furthermore, a factor which is excluded from section 722(b)(1), (2), (3), or (4) by a condition or limitation thereunder [cannot] be a ground for relief under section 722(b)(5). Section 722(b)(5) is limited by its terms to "any *other* factors * * *," and lays down the rule that any relief thereunder should not be inconsistent with the principles, conditions and limitations of section 722(b).

(B) Principles, conditions and limitations.

The basic principles underlying section 722(b) have been expressed in the introduction to this Bulletin and in the specific discussions of section 722(b)(1), (2), (3) and (4). The following paragraphs discuss limitations contained in those paragraphs which apply with equal force to section 722(b)(5).

1. *The event or condition must occur or exist during or immediately prior to the base period.*

A fundamental limitation applicable to section 722(b) generally is that the event or condition causing the inadequacy in the actual average base period net income must have occurred during or immediately prior to the base period. An event occurring after the end of the base period, or not immediately prior to the base period, which is barred by this limitation, cannot be allowed as a qualifying factor under section 722(b)(5).

To illustrate, assume that the taxpayer operated a newspaper and a radio station throughout the base period. The newspaper sustained losses for each base period year, while the radio station showed substantial profits. In January 1941 the taxpayer discontinued its newspaper business. For the year 1941, it filed a claim for relief under section 722(b)(5), alleging that the discontinuance of the newspaper is a factor affecting its business, which renders its actual average base period net income an inadequate standard of normal earnings. It contends that it is not fair and just to compare radio station earnings, reduced by newspaper losses during the base period, with radio station profits alone during the year 1941. It asks to have the newspaper losses eliminated from its base period experience.

This is not a valid claim under section 722(b)(5). If the change had been made during the base period and prior to January 1, 1940, the taxpayer would have had a valid claim under section 722(b)(4), resulting from a change in the character of the business. Since the change made in January 1941 is barred under section 722(b)(4), because it did not occur during or immediately prior to the base period, it is likewise barred under section 722(b)(5).

2. *The two-year push-back rule cannot be expanded under section 722(b)(5).*

A specific limitation contained in section 722(b)(4) relating to the push-back rule should be noted. This rule provides for an extended period of two years during which developmental growth may be considered in arriving at a normal level of earnings. Section 722(b)(4) limits the taxpayer to two years' additional growth. For example, a taxpayer which requires an additional period of three years to reach its full level of earnings cannot secure the additional year of growth under section 722(b)(4) because of the limitation under that section. It would be inconsistent with such limitation to permit the additional year of growth under section 722(b)(5).

3. *The commitment rule is limited to changes in capacity for production or operation.*

Another specific limitation is found in the commitment rule stated in section 722(b)(4). Changes in capacity for production or operation to which the taxpayer was committed prior to January 1, 1940 are recognized even though the changes were actually consummated after December 31, 1939. Commitments to make other kinds of changes in the character of the business are not recognized under section 722(b)(4). Recognition of commitments for such other changes cannot be obtained under section 722(b)(5).

To illustrate, the following commitments to change the character of the business may not be recognized under section 722(b)(5):

(a) A contract was made in December, 1939, to secure the services of a particularly efficient and successful manager formerly employed by a competitor. The new manager started in March, 1940, and was responsible for drastic changes in the operation of the plant, creating a higher level of earnings thereafter.

(b) A corporation, financed during the base period chiefly by bonds, negotiated in 1939 with a banking syndicate to float an issue of preferred stock to pay off the bonds. It was definitely committed to the transaction on December 31, 1939 but the transaction was not consummated until May 1, 1940. It contends for an elimination of the deduction for interest on its bonds during the base period.

(c) A corporation experimented during the base period with a new product which could be manufactured with equipment it was then using for other products. The new product was not manufactured commercially during the base period. In December, 1939 it entered into a contract to deliver large amounts of the new product in 1940 and 1941.

(C) Abnormally large deductions.

Certain cases alleged to be admissible under section 722(b)(5) involve abnormally large base period deductions. Abnormally large deductions alone do not form the basis for a claim under section 722(b)(5). Such deductions, however, may have been caused by some situation which otherwise qualifies the taxpayer for relief under section 722, and in the construction of normal earnings the deductions may be adjusted or eliminated. The point to be emphasized is that the abnormal deductions are not the qualifying factor, but merely the result of certain other factors which may or may not qualify the taxpayer for relief.

To illustrate, assume that the taxpayer operates an apartment house. During the year 1938, the high price of fuel due to a strike in the coal industry, together with a very severe winter, caused the taxpayer's deduction for fuel costs to be abnormally large. It claimed and was allowed an adjustment for an abnormal deduction with respect to this item under section 711(b)(1)(J) and (K) in computing its actual average base period net income. It now claims that the deductions are a factor affecting its business, and that it is entitled to further relief under section 722(b)(5). If the combination of a severe winter and high fuel prices is sufficient to constitute an unusual and temporary economic circumstance depressing its business, the taxpayer is entitled to relief under section 722(b)(2). If, on the other hand, an investigation of all the surrounding facts indicates that the fluctuations in fuel costs and the weather conditions which were encountered did not exceed the usual hazards of the business, so that the taxpayer cannot qualify under section 722(b)(2), the deductions cannot qualify it under section 722(b)(5).

(D) Accounting methods.

The taxable net income of a taxpayer is determined in accordance with the method of accounting employed by it in keeping its books and in accordance with statutory provisions supplemented by regulations and court decisions interpreting such provisions. Such taxable net income is the basis for determining excess profits net income for each base period year which in turn forms the basis for the excess profits credit based on income. The method of

accounting employed in the determination of taxable net income, such as the cash or accrual method, is not a factor affecting the taxpayer's business which may reasonably be considered as resulting in an inadequate standard of normal earnings. Such accounting methods do not affect the operation of a business. They are merely devices for recording the dollar results of completed transactions in order that periodic statements of the financial condition and progress of the business may be prepared. It is therefore the transactions themselves and not methods of accounting for such transactions which constitute the factors to be considered in determining whether or not an inadequate standard of normal earnings has resulted.

The use of a method of accounting by the taxpayer and its acceptance by the Commissioner may be taken to indicate that it clearly reflects its taxable income for a particular period. The mere fact that under some other method the taxpayer's income during the base period would have been different is not a basis for relief under section 722. To illustrate, suppose that the taxpayer has used the cash basis of reporting its income throughout its entire existence. The fact that its average base period net income would have been larger had it used the accrual method of accounting during the base period does not demonstrate that its actual average base period net income is an inadequate standard of normal earnings.

Similarly, a *change* in accounting method is not, in itself, a factor affecting the taxpayer's business within the meaning of section 722(b)(5). To illustrate, assume the taxpayer was on the cash basis of reporting its income until January 1, 1937, when it changed to the accrual basis. Assume further that if it had reported its income for 1936 on the accrual basis, its actual average base period net income would have been greater, chiefly because of certain expenses paid in 1936, but which accrued in 1935. The change is not a factor affecting the taxpayer's business within the meaning of section 722(b)(5), but merely changes the method of reporting its income. Such changes in accounting methods do not qualify for relief under this section.

(E) Qualifying cases.

The foregoing statement of cases which do not qualify under section 722(b)(5) is not to be taken as an expression of a policy that no cases will be held by the Bureau to meet the requirements under that section. In the light of the limited experience of the Bureau with situations allegedly involving the application of section 722(b)(5), however, it is not believed possible at this time to undertake to illustrate hypothetical qualifying cases.

Part VII
INVESTED CAPITAL CORPORATIONS

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Law.—Section 722(c).

Regulations.—Section 35.722-4.

(A) General rule.

In order for a taxpayer to obtain relief under the provisions of section 722(c), it must be entitled to use only the excess profits credit based on invested capital and must establish—

(1) That (A) its business is of a class described in paragraphs (1) or (2) of section 722(c) or (B) its invested capital is abnormally low as provided by section 722(c)(3); and

(2) That because the business is of such a class, or because the invested capital is abnormally low, its actual excess profits credit based on invested capital is an inadequate standard of normal earnings; and

(3) The fair and just amount representing normal earnings to be used as a constructive average base period net income.

Corporations which are limited to the use of an excess profits credit based on invested capital, and accordingly the only taxpayers to which section 722(c) is applicable, are

(1) Domestic corporations coming into existence after December 31, 1939, which are not acquiring corporations under section 740(a).

(2) Foreign corporations required to use an excess profits credit based on invested capital under the provisions of section 712(b).

Section 722(c) is intended to afford relief to certain of these corporations by applying the same standard applicable to corporations entitled to use an excess profits credit based on income under section 713, i. e., a fair and just amount representing normal earnings.

Each of the committee reports on this section contains the following statement:

> "Under existing law, a taxpayer not entitled to use the excess profits credit based on income is not entitled to relief. This places in a disadvantageous competitive position corporations commencing business after January 1, 1940, as well as other corporations deprived of such credit, if the business is of a type showing a high return on invested capital, or if, for some reason peculiar to the corporation, the invested capital is unusually low. The privilege of using the excess profits credit based on income is therefore extended to a taxpayer presently not entitled to use such credit, if the excess profits credit based upon the invested capital of such taxpayer furnishes an inadequate standard for the computation of excess profits because of one or more of the following reasons: * * *."

The right to use a constructive average base period net income is limited to those cases in which—

(1) the business of the taxpayer is of a class in which intangible assets not includible in invested capital under section 718 make important contributions to income;

(2) the business of the taxpayer is of a class in which capital is not an important income-producing factor; or

(3) the invested capital of the taxpayer is abnormally low.

There is an essential difference between cases under section 722(c)(1) or (2) and cases under section 722(c)(3). Under section 722(c)(1) or (2) the inadequacy of the excess profits credit based on invested capital is caused by the nature of the taxpayer's business. Under section 722(c)(3) the inadequacy is caused by some peculiar condition existing in the case of the particular taxpayer.

The term "invested capital" as used in section 722(c) means the invested capital as determined for excess profits tax purposes. Section 715 defines "invested capital" as follows:

> *"For the purposes of this subchapter* the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets) * * *." (Italics supplied.)

Section 716 defines "average invested capital" as follows:

> "The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year * * *."

Section 717 defines "daily invested capital" as follows:

> "The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719 * * *."

Section 719(b) defines the term "borrowed invested capital" as follows:

> "The borrowed invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day."

These definitions clearly indicate that both equity invested capital and borrowed invested capital, properly adjusted for inadmissible assets, are within the meaning of the term "invested capital" as used in section 722(c). Line 36 of Form 1121 for the calendar year 1943 is the result of the statutory computation of invested capital and therefore represents invested capital for the purpose of section 722(c).

(B) Business of a class in which intangible assets make important contributions to income.

Section 722(c)(1) deals with corporations of a class which normally realize earnings in excess of the rate of return on invested capital fixed by section 714 because the nature of their business is such that intangible assets not includible in invested capital are largely responsible for their earning power.

The mere ownership of some intangible asset is not sufficient to satisfy the requirement of this paragraph. It must be shown that in the kind of business in which the taxpayer is engaged it is usual and necessary to have this type of intangible asset. Furthermore, it must be shown that the normal earnings for this kind of business are substantially greater than the rate of return allowed under section 714 and that such earnings are directly attributable to the intangible asset.

The only "intangible assets not includible in invested capital under section 718" are those which in the nature of the taxpayer's business are customarily developed by the taxpayer or a predecessor. This is true for the reason that all assets, intangible or otherwise, are, as a technical matter, includible at their basis if they have been paid in within the meaning of section 718(a). Thus an asset could be said to be includible even though its basis is zero or it was purchased with other assets which were formerly included. The fact that an intangible asset is not *included* in invested capital may cause the invested capital to be abnormally low and thus provide grounds for relief under section 722(c)(3). The essential nature of the intangible assets described in section 722(c)(1) is that because of the character and type of the taxpayer's business the intangible assets are not acquired through channels which would enable their true value to be reflected in invested capital.

Consequently, "the business of the taxpayer is of a class in which intangible assets not includible in invested capital under section 718 make important contributions to income" only when the taxpayer establishes—

(1) Ownership of an intangible asset which was developed by it or its predecessor; and

(2) That such intangible asset is usual and necessary for the kind of business in which it is engaged; and

(3) That such kind of business normally has an earning power substantially in excess of 8 percent of invested capital; and

(4) That such earning power is directly attributable to the intangible asset.

These principles may be illustrated as follows:

Section 35.722-4(a) of the regulations gives the example of Corporation M which commenced business in 1940. Its business was of a class which necessitated the establishment of contacts with the trade in which it would obtain its customers. These contacts represent an intangible asset in its business and would not ordinarily be includible in invested capital, since the costs of operating the business while customer contacts were being developed would be ordinary and necessary business expenses which would not be capitalized.

Corporation N in 1940 purchased for cash the assets of another corporation engaged in a business in which a trade name was an important income-producing factor. Corporation N paid a fair value for the trade name, and it is reflected in its invested capital. Consequently, the N Corporation is not entitled to relief under section 722(c)(1).

Suppose, however, that Corporation N had acquired the assets in a nontaxable exchange for its stock, and that the trade name developed by the predecessor had no cost basis. The N Corporation would then qualify under section 722(c)(1), not because the asset has no basis, but because it is usual and ordinary in its line of business to earn a high rate of return on invested capital because of the presence of a trade name which is not reflected in its invested capital.

Certain intangible assets may be depreciable and accordingly their cost or other basis fully written off by charges against earnings. Where such assets were paid in for stock they are included in invested capital but such inclusion is offset by the equivalent reduction of accumulated earnings. It might appear that the intangible assets, by reason of this situation, are not included in invested capital. This interpretation is incorrect because the amortization of such assets is an offset against the earnings derived from such

intangible assets. The amortization of the assets is similar to a realization of their value by sale. Property paid in for stock is includible in invested capital even though it has been sold or otherwise disposed of. See section 35.718-1 of Regulations 112

Consequently in those cases where intangible assets have been written down there has been a transfer from asset value to earnings. The original cost or other basis of the assets remains in invested capital as property paid in for stock, and the excess of the earnings realized by reason of the possession of such assets over the amortization thereof is included in invested capital in the accumulated earnings and profits. Thus, it cannot be said that the intangible assets which have been converted into earnings are not included in invested capital. Such situations therefore do not qualify a taxpayer for relief under section 722(c)(1).

Some of the types of intangible assets which may form the basis for relief under this paragraph if they are developed by the taxpayer or a predecessor are:

(1) Patents and Copyrights.

These are grants by Government of exclusive rights of production and sale. Closely related are secret formulas and processes which, while not patented, give the taxpayer some advantage over its competitors, and result in higher earnings. These intangible assets usually relate to production, although they may relate to selling or distribution.

(2) Trade-Marks, Brands and Trade Names.

These also are grants of exclusive rights by Government to the use of certain labels or names as designations of particular products. Such intangible assets result in higher profits because of advantages in selling and distribution and are usually associated with advertising. Closely related are subscription lists and trade and customer contacts.

(3) Franchise and Licenses.

These are grants of exclusive rights to do a certain kind of business in a given locality. They may be granted by Government, as in the case of transit companies and radio broadcasting stations, or by private corporations, as in the case of a license to sell a certain product in a given territory. In these cases care should be exercised that increased earnings are shown to be attributable to the ownership of the intangible asset.

(4) Goodwill.

The term "goodwill" generally means the value of the enterprise as a "going concern". This term has been used to include some of the above intangible assets.

(C) Business of a class in which capital is not an important income-producing factor.

Section 722(c)(2) deals with those corporations in which capital is not important as an income-producing factor. These corporations are generally those which render services and which cannot qualify as personal service corporations under section 725. The rules set forth in section 35.725-2(e) of Regulations 112 for determining whether capital is a material income-producing factor should also be applied under section 722(c)(2).

(D) Abnormally low invested capital.

Section 722(c)(3) provides relief for those cases in which invested capital is abnormally low. For the meaning of invested capital for the purposes of this paragraph see discussion at paragraph (A) above. The words "abnormally low" indicate that there must be present some identifiable abnormality in the taxpayer's invested capital structure.

The amount of the taxpayer's invested capital relative to its operations and earnings does not in itself establish that it is abnormally low. That is, it may be perfectly normal for concerns in the taxpayer's industry to operate with small amounts of invested capital. Likewise, the fact that the invested capital of the taxpayer is small as compared with that of similar corporations capitalized under pre-1940 conditions does not necessarily mean that the taxpayer's invested capital is abnormally low. This is true because the amount of the invested capital required to support a given volume of business was generally larger prior to 1940 than in the subsequent period. Consequently, only those corporations whose investment was fixed under conditions similar to those encountered by the taxpayer at the time of its organization will offer proper standards for comparison. The invested capital may be abnormally low because of:

(1) An invested capital which as a whole is abnormally low in dollar amount relative to the size of the business done; or

(2) A substantial maldistribution of capital between equity invested capital and borrowed capital which results in abnormally low invested capital; or

(3) A combination of the above factors resulting in an abnormally low invested capital.

The first situation is usually caused by some favorable condition which permits the taxpayer to operate with an invested capital which is abnormally low in relation to other taxpayers in the same industry doing the same relative volume of business, as where the taxpayer leases its plant and equipment.

The second situation may be illustrated by the following example: Assume an industry in which it is normal for the capital structure to be made up equally of equity capital and borrowed capital. A corporation entered such industry in 1940 with a borrowed capital of $1,000,000 and an equity capital of only $25,000. Such distortion may result in an abnormally low invested capital for the reason that the taxpayer would have a statutory invested capital of only $525,000 (50 percent of $1,000,000 plus $25,000), while normal proportions of equity capital and borrowed capital would have resulted in invested capital of $768,750 (50 percent of borrowed capital of $512,500 plus equity capital of $512,500). However, the tax effect of this distortion is modified to the extent that the taxpayer has the benefit of a larger interest deduction which should be taken into account in constructing a base period income. See paragraph (E) below.

In certain cases there may be a combination of both of the above situations which might result in the invested capital being abnormally low.

In all cases coming within section 722(c)(3) there must be present some substantial distortion of invested capital which makes the credit provided by section 714 an inadequate standard for determining excess profits. The mere existence of a variation between the taxpayer's invested capital and the invested capital of comparable concerns in the industry is not in itself a ground for relief. There must be a substantial departure from the normal or usual

invested capital structure for the industry, and the taxpayer must demonstrate that such is true in its case for reasons peculiar to itself.

The relationship between earning ability and invested capital is not a controlling factor in determining whether or not the invested capital is abnormally low. A high earning capacity existing after December 31, 1939, may be due to the war economy. The presence of an almost unlimited market with a restricted source of supply may cause a corporation to have a high rate of inventory turnover. Such a situation would cause an increased sales volume disproportionate to the usual industry average inventory balances. For example, assume an industry in which the average rate of inventory turnover is four times a year and the invested capital is in proportion to the size of the inventories. A corporation is organized in 1941 and because of the war economy is able to secure sales the cost of which was $2,000,000. This volume of sales would normally require an inventory of $500,000 and a substantial invested capital. Because of a high inventory turnover, the corporation is able to operate on an inventory of only $250,000 and a resulting smaller invested capital. In such a situation the invested capital of the taxpayer is not abnormally low. The present operating conditions may not be compared with those producing the prior normal earnings of the industry because of the changed economic factors present when the taxpayer entered the competitive field.

Normal variations in the structure of invested capital from the average pattern of capitalization followed by the industry do not give rise to an abnormality under section 722(c)(3). The variation must be substantial in that the distortion clearly results in an inadequate credit.

(E) Construction of average base period net income.

In general.

Section 722(c) provides that a taxpayer described in section 722(c)(1), (2), or (3) shall be considered to be entitled to use the excess profits credit based on income, using the constructive average base period net income determined under subsection (a). The relief afforded a taxpayer under section 722(c), therefore, parallels that given a taxpayer which qualifies under section 722(b), the relief under either subsection taking the form of a constructive average base period net income. Accordingly, in the reconstruction of base period earnings for a section 722(c) taxpayer the principles applicable to the determination of a constructive average base period net income for taxpayers described in section 722(b) will govern.

In general, the problem of constructing base period net income for a taxpayer which commenced business after 1939 is similar to that which is met by taxpayers which commenced business or changed the character of their business late in the base period. In both cases it is necessary to determine the normal operating conditions of the taxpayer within the framework of the base period. For a taxpayer which is deemed under the commitment provisions to have changed its character on December 31, 1939 the determination of the taxpayer's normal operating conditions will require a complete construction of such conditions for the entire base period. The determination of base period normal operating conditions for a section 722(c) taxpayer requires a similarly extensive construction of such conditions.

One of the basic principles underlying the determination of normal earnings in the section 722(b)(4) case enables a taxpayer which was in its development stage during the base period to establish what is level of income and operations would have been after its initial development difficulties were

solved. An unlimited period for development, however, was not permitted the section 722(b)(4) taxpayer. This period was limited to an experience two years longer than that actually had during the base period.

The taxpayer coming within section 722(c) presents essentially the same reconstruction problems as do the section 722(b)(4) taxpayers and the identical problems as the commitment taxpayer. Uniform and equitable application of the principles of reconstruction requires that the section 722(c) taxpayer should not be treated in a more favorable or in a less favorable manner than the section 722(b)(4) taxpayer. The section 722(c) taxpayer should not be precluded from having the benefits of a post-development period, nor should it have the benefits of a development period longer than that afforded to the section 722(b)(4) taxpayer. Accordingly, in determining the taxpayer's normal level of earnings and of operations as of December 31, 1939, the taxpayer will be assumed to have commenced business on December 31, 1937. Moreover, where the section 722(c) taxpayer is a member of an industry which, during the base period, was depressed because of unusual and temporary economic events or was cyclically depressed, or which has sporadic and intermittent periods of high earnings the principles of reconstruction for taxpayers coming within the provisions of section 722(b)(2) and (3) will also be applicable.

In view of the stepped-up tempo of business activity because of war conditions subsequent to the end of the base period, corporations commencing business after December 31, 1939, would generally pass through an initial development stage more rapidly than they would have done if they had commenced business during or shortly prior to the base period. For example, a corporation commencing business in January 1941, even in an industry not producing goods for direct war use, might attain the same level of operations and earnings within one year that it would have taken two years or more to attain if it had commenced business well within the base period. Therefore, no significance can be attached to the actual rate of development or earnings of a taxpayer that began business subsequent to the end of the base period. Constructive normal earnings can never be based on post-1939 circumstances. The constructive normal earnings of a taxpayer under section 722(c) are the earnings it would have obtained from normal operations during a period of normal conditions for general business. The third and fourth paragraphs of section 35.722-4(c) of Regulations 112 indicate the general principles which are applicable to the construction of average base period net income in section 722(c) cases.

In those instances in which the inadequacy of the excess profits credit is caused by a disproportion between equity capital and borrowed capital, a possible duplication should be avoided in the relief to be allowed. A taxpayer having an abnormally large proportion of borrowed capital will have an invested capital which is abnormally low because of the fact that only 50 percent of the borrowed capital is includible as invested capital. If the taxpayer uses the excess profits credit based on invested capital, its excess profits net income is computed under section 711(a)(2) and 50 percent of the deduction for interest on its borrowed capital is eliminated. If, however, it established its right to relief under section 722(c), it will be deemed to be entitled to use the excess profits credit based on income, and any relief allowed will be in the form of a constructive average base period net income. Its excess profits net income will therefore be computed under section 711(a)(1) and the deduction for interest on borrowed capital will be allowed in full. If a constructive

average base period net income were premised on a capital structure with a normal proportion of borrowed capital, interest would be deducted in such determination only on the normal amount of borrowed capital. If no adjustment in interest is made, the taxpayer would receive a double benefit. First, interest on the abnormal borrowed capital would be allowed in full during the excess profits tax taxable year in computing excess profits net income, and second, the constructive average base period net income would be computed without a corresponding deduction for interest.

In order to eliminate this duplication, the constructive average base period net income otherwise computed must be reduced by the amount of the interest paid or accrued on that part of the borrowed capital which caused the abnormally low invested capital. This may be illustrated by the following example, which for the purpose of illustrating the computation, assumes that the taxpayer is a member of an industry which normally operates with no borrowed capital. It assumes also that the going rate of interest on borrowings in the base period was 5 percent for the taxpayer involved. If the rate at which a particular taxpayer could have borrowed during the base period varies from the rate assumed, the reconstruction of base period net income would in such case be based upon such other rate.

Illustration

	Data for Taxpayer
Capital Structure	
Cash paid in for stock	$ 100,000
Total borrowed capital	1,400,000
Total capital	$1,500,000
Statutory Invested Capital	
Equity invested capital	$ 100,000
50% of borrowed capital	700,000
Average invested capital	$ 800,000
Constructive average base period net income without deduction for interest	$ 150,000
Excess profits net income before interest deduction	$ 200,000
Interest on borrowed capital at 5%	70,000
Excess profits net income	$ 130,000

Computation of Adjusted Excess Profits Net Income

Without interest adjustment:	
Excess profits net income	$ 130,000
Less: Specific exemption	5,000
Constructive credit (95% of $150,000)	142,500
	$ 147,500
Adjusted excess profits net income	None

The zero adjusted excess profits net income results because of the duplication caused by the subtraction of the $70,000 interest deduction in the computation of excess profits net income for the taxable year without a corresponding deduction for interest in computing the constructive average base period net income. The proper adjustment to eliminate this duplication is as follows:

Excess profits net income	$ 130,000
Less: Specific exemption	5,000
* Constructive credit	76,000
	$ 81,000
Adjusted excess profits net income	$ 49,000
* Constructive average base period net income without interest deduction	$ 150,000
Less: Adjustment for interest on borrowed capital	70,000
Constructive average base period net income adjusted	$ 80,000
Credit—95%	$ 76,000

In the usual case in which the taxpayer is a member of an industry which normally operates with some borrowed capital, but the ratio of its borrowed capital to its total capital is considerably larger than such industry ratio, the adjustment to the constructive average base period net income will be limited to the interest on that part of its borrowed capital which is in excess of the amount representing the normal ratio.

Application of December 31, 1939 limitation to cases under section 722(c).

Section 722(a) provides in part as follows:

> "In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer * * * except that, in the cases described * * * in section 722(c), regard shall be had to * * * the nature of the taxpayer and the character of its business under section 722(c) to the extent necessary to establish the normal earnings to be used as the constructive average base period net income."

Events or conditions affecting the taxpayer which occurred after December 31, 1939, shall be taken into account in determining normal earnings to be used as a constructive average base period net income only to the extent necessary to establish the *nature* of the taxpayer and the *character* of its business. Such events may be used to determine the kind of business, its capacity, the nature of the product, methods of distribution, and the scope of its activities. The corporate structure and the type of capitalization shall also be regarded. The actual operations of the taxpayer after December 31, 1939, including selling prices, manufacturing or distribution costs, volume of sales, or other factors which may be affected, directly or indirectly, by the expanded economy shall not be used in determining the constructive average base period net income. The war economy creates an abnormal picture of business activity and therefore such period can not be relied upon to develop normal earnings.

Capital changes.

As pointed out above, if relief is allowed under section 722(c), the taxpayer will be deemed to be entitled to use an excess profits credit based on income, and adjustments to excess profits net income will be made under section 711(a)(1) in lieu of the adjustments provided by section 711(a)(2). Likewise, adjustment to the excess profits credit for capital changes after the beginning of the first excess profits tax taxable year will be computed in the manner applicable to a taxpayer entitled to use the excess profits credit based on income under section 713.

Sections 713(g) and 743 provide for adjustments to the excess profits credit on account of capital changes, and provide generally for capital additions and reductions occurring after the beginning of the first excess profits tax taxable year of the taxpayer. The last sentence of section 722(c) places a restriction on this general rule insofar as cases falling under that subsection are concerned. It reads as follows:

> "For the purposes of section 713(g) and section 743, the beginning of the taxpayer's first taxable year under this subchapter shall be considered to be that date after which capital additions and capital reductions were not taken into account for the purposes of this subsection."

It therefore follows that no adjustment should be made for capital additions or capital reductions occurring during the period which is used in determining the nature and character of the taxpayer. This period, which is not to be confused with the two-year push-back period under section 722(b)(4), will vary with the circumstances present in each case and will represent the time necessary to permit the corporation to reach its normal capital structure. It includes the time necessary for the corporation to develop its nature and character as originally contemplated at the time it came into existence. The intention of the incorporators may be ascertained from an examination of the minutes of the corporation and other pertinent data. The reason for the issuance of new stock at later dates should be ascertained in order to determine whether the new capital is for purposes of expansion beyond the size and character originally contemplated or is to carry out the originally planned development of the company.

This modification of the rule relating to capital additions may be illustrated as follows:

Assume that a corporation began business in January, 1941, and has established the fact that its invested capital is abnormally low. It adopted the calendar year as its taxable year and at the end of 1941 had reached a capital structure of a kind and size originally contemplated. At various times during the year 1941 capital additions were made for such development. In constructing normal earnings such capital additions are taken into account for the purpose of determining the nature of the taxpayer and the character of its business, and are disregarded in computing the adjustments for net capital additions or reductions under section 713(g) and section 743.

If the period used in determining the nature of the taxpayer and the character of its business ends on an interim date during the taxable year, such date is deemed to be the beginning of the taxpayer's first taxable year for the purpose of computing capital additions and reductions under sections 713(g) and 743. This does not change the taxpayer's excess profits tax taxable year. It only establishes the date after which capital changes (and changes in excluded capital) are to be taken into account. For example, assume a calendar year corporation was organized January 15, 1941 and the period of time necessary to determine its nature and the character of its business ended on July 15, 1942; thereafter, on October 1, 1942, there was paid in additional capital. For the purpose of computing the adjustment for net capital additions, any addition occurring within the period ending July 15, 1942, must be disregarded. Adjustment will be made only for capital additions occurring after July 15, 1942, and will be effective only for the number of days for which it was paid in during the taxable year. In this example, for the year 1942, the capital paid in on October 1, 1942, will be taken into account to the extent of 91/365.

Variable credit rule.

Under section 722(c) the nature of the taxpayer and the character of its business may in some cases not be fully developed until a period subsequent to the excess profits tax taxable year for which the credit is being computed. Moreover, the constructive average base period net income, determined under the two-year push-back rule as described above, may in some cases exceed the level of earnings which would *normally* have been reached by the taxpayer during a given excess profits tax taxable year. In a case involving either or both of these situations, the fair and just amount for each excess profits tax taxable year prior to the constructive attainment of the full level of normal earnings will be an amount less than such constructive average base period net income.

To illustrate both situations, suppose a taxpayer came into existence and commenced operations at the beginning of 1941, and reached its full development with respect to capital structure and type of operations by the beginning of 1942. Suppose, further, that under normal conditions the taxpayer would have reached its full level of normal earnings two years after attaining its full nature and character, i. e., by the end of 1943. Only for the year 1944 and following taxable years will the constructive average base period net income established under the push-back rule be applicable in full. For the taxable years 1941, 1942 and 1943 a different and smaller constructive average base period net income is applicable.

The principles and methods to be applied to such cases are identical in all respects to those applicable to commitment cases under section 722(b)(4), described in Part V, Subpart II, paragraph (F). Reference is made to that discussion.

In any case in which the factors upon which relief is based are no longer present in subsequent excess profits tax taxable years, no relief under section 722(c) will be allowed in such later years. These factors may no longer exist because additional capital may have been paid in, or surplus accumulated from earnings, or the intangible assets may have been disposed of. For example, it might be established in a given case that invested capital of $1,000 is abnormally low under subsection 722(c)(3) for the year 1941 and that the constructive average base period net income should be $12,000. On January 1, 1942 additional capital of $99,000 was paid in, and the resulting total of $100,000 represents normal capital. The credit for 1942 under the invested capital method including the allowance for new capital will amount to 8 percent of $125,000 or $10,000. A credit in 1942 of $10,000 will be allowable under section 714 and no relief will be allowable under section 722(c)(3).

Part VIII
MISCELLANEOUS PROBLEMS

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(A) Multiple bases for relief and membership in more than one industry.

(1) *Multiple bases for relief.*

The preceding discussion has been limited, for the most part, to the procedure for determining relief under a single provision of the statute. Certain principles can be laid down, and certain procedures suggested, when relief involves more than one of the subsections of section 722, or more than one type of change in character under section 722(b)(4). The establishment of one valid basis for relief does not, of course, render any less rigorous the proof necessary to bring a second event or circumstance within the scope of section 722.

It should be noted at the outset that certain of the relief provisions are mutually exclusive, so that the problem of multiple relief will not arise. No taxpayer, for example, can qualify under both section 722(b) and section 722(c), since they are applicable respectively to taxpayers which are and are not entitled to use the excess profits credit based on income pursuant to section 713. Likewise, in view of the nature of the qualifying circumstances, no taxpayer which is a member of only one industry can qualify under both sections 722(b)(3)(A) and 722(b)(3)(B). No industry can be characterized by a well defined cycle of profits and at the same time be characterized by sporadic and intermittent periods of high production and profits.

There may be cases, however, where two or more valid bases for relief exist with respect to a given taxpayer. It is impossible to discuss all of the numerous combinations in which multiple bases for relief may occur. In most cases the application of sound judgment should leave little doubt concerning the proper method of handling any given case where multiple bases of relief are applicable. No universal rule can be laid down, but the following discussion may be suggestive of principles and methods to be applied.

It may easily happen, for instance, that events or circumstances which qualify under both sections 722(b)(1) and 722(b)(2) may be found in a given case. If the two circumstances occur at different times, the reconstruction may in general be applied independently and cumulatively, just as if two section 722(b)(1) events occurred at different times in the base period. Care must be exercised, however, if the two events affected the taxpayer at the same time. It is conceivable that in this case the combined effect of the two circumstances

might be either greater or less than the sum of the adjustments produced by the separate consideration of the two. If, for instance, the taxpayer experienced a flood at a time when the industry of which it is a member was experiencing a temporary economic depression affecting the taxpayer, care must be exercised that neither insufficient nor excessive relief is granted because of duplicating computations.

Another type of case to be considered is that where the primary basis of relief is the existence of a variant profits cycle under section 722(b)(3)(A), while an event or circumstance which might qualify for relief under sections 722(b)(1) or 722(b)(2) is alleged to have occurred. In most of these cases it would appear to be necessary first to make a reconstruction for the former in order to ascertain whether from the business cycle aspect the taxpayer's earnings were depressed. This follows from the fact that there is no need to investigate whether the industry of which the taxpayer is a member has a variant profits cycle unless the taxpayer's earnings were depressed in the base period. As discussed in Part IV, this can be determined by a comparison of base period earnings with average earnings over a longer period.

The same analysis would apply in almost identical form to sporadic profits cases under section 722(b)(3)(B). The nature and extent of base period depression due to sporadic and intermittent periods of high production and profits could hardly be determined until the effect of any temporary and unusual depressing influence in the base period had been ascertained and corrected.

Still another type of case to be considered is that where a change in character under section 722(b)(4) is coupled with an event or circumstance qualifying for relief under one of the other paragraphs of subsection (b). Here again, it would generally be desirable to make a reconstruction first for any abnormal circumstance under section 722(b)(1) or (2) even before concluding that reconstruction is called for under section 722(b)(4), since a change in character will qualify the taxpayer for relief only if the change in character has brought about an increased level of normal earnings. Before it can be determined that a higher level of normal earnings resulted from the change, normal earnings must be determined prior to the change; in other words, abnormalities under section 722(b)(1) or (2) must be removed in order to determine that reconstruction is warranted under section 722(b)(4).

Having made the adjustments for any abnormalities under section 722 (b)(1) or (2), reconstruction of income can be made for the change in the character of the taxpayer. If the prior experience of the taxpayer can serve as a basic source of the information for this reconstruction (as discussed in Part V, Subpart II), then it is the adjusted experience of the taxpayer excluding the effects of the abnormalities, that will be employed for this purpose.

If the taxpayer had a depression due to a variant profits cycle or a sporadic profits experience under section 722(b)(3), and at the same time had a change in character under section 722(b)(4), the method of procedure will depend upon the nature of the change in character. If the change in character is of such a nature as to put the taxpayer into an industry different from that of which it was a member prior to the change, then the prior experience of the taxpayer is immaterial. Normal income for the changed taxpayer is to be determined solely with reference to its changed character, and any possible variant cycle or sporadic profits experience, in order to be pertinent, must be demonstrated for the industry of which the taxpayer has become a new member, rather than for the industry of which it had formerly been a member. If, on the other hand, the change in character of the taxpayer is of a less drastic

nature so as to leave it a member of the same industry, then the extent of the base period depression of the taxpayer's earnings due to the section 722 (b)(3)(A) or (B) circumstance must ordinarily be determined first; the increase in the normal earnings due to the section 722(b)(4) change in character must then be determined; and finally the two should be combined in an appropriate manner.

There remains to be considered the situation in which the taxpayer has demonstrated two or more changes in character under section 722(b)(4) which constitute valid bases for relief. Subject to the limitations discussed in Part V, this should occasion no particular problems in reconstructing base period net income, since, as previously stated, the objective is the normal base period earnings for the taxpayer as it existed after all qualifying changes in character. Only one reconstruction of net income is to be made, based upon the normal operating conditions of the taxpayer under its changed character as of the end of the base period.

(2) *Membership in more than one industry.*

The situation may often arise where a taxpayer is a member of more than one industry, for example, where two departments or divisions of a manufacturing plant produce two unrelated, or largely unrelated, sets of products. Another example might be where a taxpayer manufactures a series of products and also has its own retail marketing organization. If either such combination is customary among the competitors of the taxpayer, then in all probability the combination can be regarded as a single industry, and the taxpayer can be treated as a member of this industry. The present discussion is intended to apply to those taxpayers the operations of which fall into two or more categories, each of which is clearly recognized as belonging to a separate industry.

In such cases the taxpayer must be regarded from a dual point of view with respect to relief under section 722. On the one hand, reconstruction must in the first instance be made separately for each of the portions of the business of the taxpayer to which a given basis of relief applies, for practical as well as logical reasons. Thus, a qualifying circumstance under one paragraph of section 722 (b) may affect only a single portion of the taxpayer's operations, and obviously reconstruction must start at this point.

On the other hand, the entity for which the statute directs that base period net income be reconstructed is the taxpayer, i.e., the whole business of the taxpayer regarded as a unit. This is an application of the principle previously noted that abnormalities of any sort, reflected in the base period, are to be recognized and adjusted for in reconstruction. Abnormally high income received from a part of the business of the taxpayer is to be adjusted downward in the process of reconstruction. The operations of all portions of the business of the taxpayer must be carefully analyzed to assure that the final result will represent the normal income during the base period for the taxpayer as a complete entity.

(B) Avoidance of post-1939 experience in the computation of constructive average base period net income.

Law.—Section 722(a), last sentence.
Regulations.—Section 35,722-2(a).

(1) *In general.*

Reference has frequently been made in preceding sections of this Bulletin to the statutory prohibition against consideration of post-1939 events and

conditions in the determination of the constructive average base period net income. The importance of the prohibition, and its effect in the process of reconstruction, require that a more extended treatment of the subject be made.

The last sentence of section 722(a) expresses an explicit statutory prohibition against regarding post-1939 events and conditions in the determination of the constructive average base period net income except in two specified situations, namely:

(a) Cases under section 722(c) in which the taxpayer came into existence after December 31, 1939, and,

(b) Cases under section 722(b)(4) in which a change in capacity for production or operation was consummated after December 31, 1939 as the result of a commitment entered into by the taxpayer prior to January 1, 1940, or in which assets of a competitor engaged in disseminating information through the public press were acquired by the taxpayer prior to May 31, 1941.

As stated by the regulations (Regulations 112, section 35.722-2(b)), the basis for excluding post-1939 events or conditions is as follows:

> "Such events or conditions are deemed to be integral parts of the war economy; they cannot therefore be accepted as either accurate or reliable determinants of normal operations or normal earnings."

(2) *Unauthorized use of post-1939 events or conditions.*

Despite the statutory prohibition, use has been made of post-1939 experience to determine the level of earnings attainable through the use of the push-back rule and in the general determination of the constructive average base period net income in the following ways:

(a) Direct use of actual earnings experience after 1939.

(b) Direct use of actual earnings experience after 1939, purportedly adjusted to eliminate the effect of the war economy.

(c) Use of certain relationships or ratios obtained from post-1939 experience of the taxpayer or its industry.

The first method, which uses post-1939 earnings experience directly and without adjustment, is advanced on the ground that the post-1939 experience of the particular taxpayer was not affected by the war, or was, in fact, depressed as a consequence of the war.

Under the second method, it is admitted that the post-1939 experience of the taxpayer reflected the effects of the war, but effort is made to remove such effects from the post-1939 experience through such measures as the elimination or adjustment of income received from war contracts, or the decrease in volume of sales or margin of profit by a flat percentage.

The third method avoids direct use of post-1939 experience but attempts to establish relationships between the base period and the subsequent period. Thus, in determining the productivity of unskilled or untrained labor for the purposes of the two-year push-back rule, actual productivity per man hour after December 31, 1939 is stated to represent the productivity of labor with two years additional experience. Ratios of increases of indirect labor, material, and overhead costs to increased capacity actually experienced after December 31, 1939 have been asserted to represent the correct ratios to apply to the base period in determining cost of increased production attributable to increased capacity. Finally, the ratio of sales of a new product to an old product during 1940 or 1941 has been used as the basis for constructing sales of the new product during the base period.

In view of the clear and unequivocal statutory prohibition, none of the foregoing methods and supporting arguments is valid or acceptable. Moreover, the history and purpose of section 722 clearly establish the intent of Congress that there be strict compliance with the provisions of the statute and that its prohibition be not avoided by the indirect use of post-1939 events or conditions. Thus, the provision for a backward extension of experience in the determination of a normal earning level under the push-back rule, instead of a provision to include the first two excess profits tax taxable years, and the careful delineation of the few exceptions to the statutory prohibition clearly reflect and reinforce the explicit statutory expression of Congressional intent.

(3) *Use of post-1939 experience in cases involving the commitment rule, acquisition of competitor's assets, and section 722(c).*

The exceptions to the general rule relating to post-1939 experience are for strictly limited purposes. Under the last sentence of section 722(b)(4) the increased capacity or the acquired assets which are constructively placed at December 31, 1939 were not actually part of the taxpayer's business until after that date. It is therefore necessary to look beyond December 31, 1939 to establish the kind of taxpayer for which normal earnings are to be reconstructed. Furthermore, in the application of the variable credit rule (Part V, Subpart II (F)) the extent to which the committed for capacity or acquired assets would normally have entered into the operations of the taxpayer must be determined. In this connection, Regulations 112, section 35.722-3(d) provide in part as follows:

> "For an excess profits tax taxable year, prior to the attainment of full normal operating capacity, the fair and just amount of normal earnings attributable to a change in capacity for production or operation consummated after December 31, 1939, may be determined either by multiplying the full normal earnings attributable to normal operating capacity for the base period (or a comparable period) by a percentage representing the extent to which such change is reflected in the taxpayer's business for such year, or by determining normal earnings upon the basis of the operating level which normally would have been reached by such change during such year. To the extent necessary to determine the nature of the change in the capacity for production or operation, and the extent to which such change has been reflected in the taxpayer's business, regard may be had to facts existing after December 31, 1939. Although no regard should be had to actual earnings after December 31, 1939, as indicative of the amount of normal earnings attributable to the change, ratios existing between such earnings and earnings from other operations of the taxpayer or of similar taxpayers or an industry of which the taxpayer is a member may be taken into account."

The use of the ratios described in the regulations is limited to the determination of the extent to which the changed capacity is reflected in the taxpayer's business during an excess profits tax taxable year. They may not be used to determine the normal earnings attributable to the change. Just as actual dollar earnings after December 31, 1939 present an inaccurate picture of normal earnings, so also ratios based on such earnings may produce a distorted picture, not only of the relationship between the normal operations of the changed capacity and the taxpayer's total business, but also of the taxpayer's relationship to its industry.

In section 722(c) cases the ratios referred to above may be used to the extent necessary to establish the nature of the taxpayer and the character of its business. Thus, here again, the use of post-1939 experience is limited to the extent necessary to establish the kind of taxpayer for which reconstruction

will be made. The actual reconstruction, however, will be made within the framework of the base period and under the normal operating conditions determined for such period.

Reference is made to Part V of this Bulletin for discussion of the use of post-1939 experience in cases involving the commitment rule, and to Part VII in cases involving commencement of business after December 31, 1939.

(C) Taxpayers with base period ending after December 31, 1939.

Law.—Section 722(a) and (b).

(1) *General rule.*

As a means of measuring the relief to which the taxpayer is entitled, section 722 provides for the determination of a constructive average base period net income to be used "in lieu of the average base period net income otherwise determined" under subchapter E of chapter 2 of the Internal Revenue Code. Many taxpayers claiming relief under section 722 have base periods ending after December 31, 1939. Section 722(a), however, prohibits any consideration of events or conditions occurring or existing after December 31, 1939 in determining constructive average base period net income.

In making such determination, there is no authorization in section 722 for changing the taxpayer's statutory base period determined under the provisions of section 713(b)(1). Although in some cases, notably under section 722(b)(3), it may be necessary to determine the constructive average base period net income by reference to the income of some other period or periods in the taxpayer's history, the amount so determined is nevertheless a substitute for the earnings during the statutory base period. Any period after December 31, 1939 is considered unacceptable as a measure of normal earnings.

Since actual earnings for any portion of the base period after December 31, 1939 cannot enter into the computation of the constructive average base period net income, since income for the entire actual base period must be determined, and since the actual statutory base period cannot be changed to a base period ending on December 31, 1939, the following rule is required: In any construction of average base period net income for a base period ending after December 31, 1939, it is necessary to reconstruct the portion of the base period after December 31, 1939.

To illustrate, assume the taxpayer's base period is the four fiscal years ended November 30, 1940. It had a strike in 1937 which forms the basis for a claim for relief under section 722(b)(1). In determining the constructive average base period net income, it is not sufficient merely to eliminate the effects of the strike. The statutory prohibition in section 722(a) bars the use of the actual earnings from January 1 to November 30, 1940. Instead, there must be reconstructed for this period a substitute net income representing earnings which the corporation as of December 31, 1939 could reasonably have expected to earn in this period under normal operating conditions, uninfluenced by the war economy.

(2) *Right to relief resulting from an event occurring during the base period but after December 31, 1939.*

Section 722(b) defines the situations in which the taxpayer's excess profits tax is to be considered excessive and discriminatory so that it may be entitled to the relief prescribed in section 722(a). In each situation, something must have happened immediately prior to or during the base period which caused an inadequacy in the actual average base period net income. In paragraph (1)

of section 722(b) it is an interruption of operation; in paragraph (2), temporary economic depression; in paragraph (3), cyclical or sporadic depression; in paragraph (4), a commencement or change in character of the business; in paragraph (5), other factors affecting the taxpayer's business.

The statutory prohibition against regarding post-1939 events relates only to the *determination of the constructive average base period net income.* It does not affect the ascertainment of the event or factor under section 722(b) which qualifies the taxpayer for a reconstruction of base period net income, and which may occur at any time during the base period. Consequently, any factors under section 722(b)(1), (2), (3), (4) or (5), affecting any part of the base period after December 31, 1939 may be considered in determining whether the requirements of section 722(b) have been met. In making the reconstruction, however, no regard may be had to the actual post-1939 experience of the taxpayer.

To illustrate, assume that the taxpayer, with a base period ended November 30, 1940, had an unusual strike during September and October 1940. Since the strike occurred during the base period, it may be considered in determining whether there is an inadequacy in the actual average base period net income. In determining the constructive average base period net income, however, the strike and the actual income after December 31, 1939 are both disregarded. Thus, in eliminating the effect of the strike, normal earnings for the eleven months in 1940 are reconstructed by also eliminating any effects of the post-1939 war economy.

Assume, on the other hand, that a taxpayer with a base period ended November 30, 1940, bases its claim under section 722(b)(4) on a change in capacity effected during July 1940, to which it was not committed prior to January 1, 1940. The change in capacity, having occurred during the base period, is a factor which may be considered under section 722(b)(4). But in the construction of normal earnings, no regard can be given to the change in capacity because it occurred after December 31, 1939. Consequently, no additional earnings resulting from the changed capacity can be included for any part of the base period. The taxpayer would, therefore, not satisfy the requirements of section 722 and its claim based upon the increased capacity could not be sustained. It will thus be seen that any claim under section 722(b)(4) based solely upon a change in the character of the business made after December 31, 1939 cannot be allowed. It should be noted, however, that if the change resulted from a commitment made prior to January 1, 1940, the change is deemed to have been made on December 31, 1939 and would not be disqualified.

(3) *Application to the two-year push-back rule.*

The two-year push-back rule, as explained in Part V, is a statutory device for determining the earning level which will serve as a basis for reconstructing the entire base period. Since its use is part of the process of reconstruction, it is subject to the statutory post-1939 prohibition contained in section 722(a), and the actual earning level reached after December 31, 1939 must be disregarded. Instead, for the purpose of the two-year push-back rule, there will be substituted a constructive earning level which the taxpayer could reasonably have been expected to reach by the end of the base period under normal conditions and in the absence of abnormal economic factors induced by the war. If this constructive earning level is lower than the earning level that would have been reached had the change been made two years earlier, the taxpayer is given the benefit of the two-year expanded experience. If the constructive earning level without the benefit of the two-year rule is as high as, or higher

than, the level reached after the application of this rule, reconstruction is to be made on the basis of the original constructive earning level. In no event is the actual earning level attained by the end of the base period to be used.

For example, assume that the taxpayer, with a base period ended November 30, 1940, changed its capacity for production on October 1, 1939. Assume that as a result of this change it reached an actual earning level of $100,000 by November 30, 1940. Assume it can be shown that on the basis of the development of the additional capacity by December 31, 1939 and without regard to conditions existing after that date, the earning level that normally would have been reached by November 30, 1940 would have been $75,000. Assume further that had the change been made two years earlier (on October 1, 1937), the taxpayer could not reasonably have expected under normal conditions to reach by November 30, 1940, an earning level any greater than $75,000. Under these facts the average base period net income is reconstructed on the basis of the $75,000 earning level. On the other hand, if the two-year expanded period would, by November 30, 1940, have resulted, under normal conditions, in an earning level of $110,000, the reconstruction would be based on $110,000 instead of $75,000. In neither case would the actual earning level of $100,000 as of November 30, 1940 be used.

(D) Treatment of adjustments under section 711 in computation of constructive average base period net income.

Regulations.—Section 35.722-3(b) (3).

(1) *In general.*

In computing the constructive average base period net income, a substitute for the actual average base period net income is being determined for use as a standard of normal earnings. The term "average base period net income" is defined in the statute. Generally, the statutory rules provided in section 711(b) for determining the excess profits net income for the base period years will be applied in the computation of the constructive average base period net income, so long as the application of these rules does not conflict with the basic purpose of section 722, which is to obtain a standard of *normal* earnings. The following subparagraphs of section 711(b)(1) will therefore generally apply:

Section 711(b)(1)(B) Gains and Losses from Sales or Exchanges of Capital Assets.

Section 711(b)(1)(C) Income from Retirement or Discharge of Bonds.

Section 711(b)(1)(D) Deductions on Account of Retirement or Discharge of Bonds.

Section 711(b)(1)(E) Casualty, Demolition and Similar Losses.

Section 711(b)(1)(F) Repayment of Processing Tax to Vendees.

Section 711(b)(1)(G) Dividends Received.

Subparagraphs (A), (H), (I), (J) and (K) of section 711(b)(1) are discussed below.

(2) *Adjustment of the deduction for income tax.*

Section 711(b)(1)(A) provides for the deduction of income taxes in computing excess profits net income and is applicable only in computing the excess profits credit for excess profits tax taxable years beginning prior to January 1, 1941. It is not applicable for the purpose of computing the carry-over from these years.

In cases in which a constructive average base period net income is being determined for an excess profits tax taxable year subject to the provisions of section 711(b)(1)(A), it is necessary to make the deduction for income taxes. Since the object of section 722 is to obtain normal earnings for the purpose of a comparison with the excess profits net income of the taxable year, and such income of the taxable year reflects a deduction for income taxes, the adjustment must be made for the amount of income taxes that would have been paid on the constructive income. It will therefore be necessary to recompute the income tax to be used in lieu of the actual income taxes which were assessed on the original returns for the base period years or as a result of subsequent deficiencies or over-assessments. Since the construction under section 722 will generally result in increasing the income, the income taxes also will usually be increased. In making this adjustment, the taxpayer is not required to pay the additional income taxes, and the provisions of section 734 relating to inconsistent position in prior years are not applicable.

For the years 1936 and 1937, income taxes under chapter 1 included a tax on undistributed profits. For 1938 and 1939, distributed and undistributed profits were taxed at different rates. In all base period years, therefore, the amount of dividends distributed is a factor in determining the amount of income tax. In recomputing the income taxes on the constructive income under section 722, the question arises as to what amount of dividends paid is to be used in the computation.

No fixed rule or formula can be given for the determination of the dividends deemed to have been paid. The amount to be used will depend upon what amount would normally have been distributed in the light of the constructive earnings determined under section 722. It will therefore be necessary to consider the dividend policy of the corporation, the nature of the constructive earnings, and any other facts which indicate what distribution would normally have been made.

To illustrate, assume that a corporation had a long established policy of distributing approximately 50 percent of its earnings as dividends each year. During 1937 it had a fire which qualified it for relief under section 722(b)(1). In recomputing income taxes for the base period the dividends actually paid should be increased in the same proportion as the net income was increased in the reconstruction.

On the other hand, assume that a corporation has qualified for relief under section 722(b)(4) as a result of a new plant built in 1939. It has a consistent policy of dividend distributions, but a contract for financing of the new plant provided that no dividends should be paid for a period of ten years until the loans had been repaid. In the recomputation of income taxes for the base period years no dividends may be considered to have been paid, even though some dividends were actually distributed. For such a corporation, it would have been normal to make no distributions. However, for 1936 and 1937 the corporation should be considered as having had a contract restricting dividends and its undistributed profits tax computed accordingly.

A similar problem will arise in the determination of the capital stock tax and declared value excess-profits tax to be deducted in computing the constructive average base period net income. Again, no fixed rule or formula can be given. However, the capital stock and declared value excess-profits tax depend upon how successfully the corporation can estimate its probable income. Generally, it should be considered that the estimate of increased

income would have been relatively as accurate as that made on actual income. To illustrate, assume that the corporation declared a capital stock valuation of $500,000 but had to pay declared value excess-profits tax on 5 percent of its income. After reconstruction of net income under section 722, its capital stock tax and declared value excess-profits tax should be adjusted so that 5 percent of its reconstructed net income is subject to declared value excess-profits tax. It should be noted that this approach to the problem may have to be modified to meet the peculiar circumstances in some cases.

The discussion so far has been confined to the adjustments necessary because of the deduction of income taxes in the computation of the excess profits credit. It has been assumed that the constructive income, prior to this adjustment, had been computed for each of the base period years. In all variant profits cycle cases under section 722(b)(3)(A), and usually in sporadic profits cases under section 722(b)(3)(B), as discussed in the paragraphs above relating to section 722(b)(3), the constructive average base period net income will, in the first instance, be computed as a single figure, rather than as the average of four figures for the respective years of the base period. In these cases it will be necessary, for claims relating to taxable years beginning prior to January 1, 1941, to make an allocation of the constructive average base period net income to the several base period years.

No one method of allocation can be prescribed for all cases; any logical and equitable method is allowable. The following are suggestive:

(a) Especially in section 722(b)(3)(A) cases, there is some reason for discarding the actual year-to-year pattern of the taxpayer's actual profits (and deficits), and substituting the base period profits pattern of all corporations, since the basis for relief is a variant profits cycle. As shown by Part 2 of *Statistics of Income*, the compiled net profit or loss of all corporations, less tax-exempt income (an approximation of excess profits net income) during the base period was as follows, expressed as percentages of the base period average:

1936	117.3
1937	118.3
1938	43.2
1939	121.2
Average	100.00

These indexes may be employed to allocate the constructive average base period net income to the individual years of the base period by multiplying the constructive average successively by the four indexes, keeping in mind that each index is a percentage. Thus, if constructive average base period net income of a taxpayer under section 722(b)(3)(A) has been determined to be $70,000, then the amount allocable under this method to 1936 would be $70,000 x 1.173, or $82,110. Similar computations yield the results for 1937, 1938 and 1939, and the computations can be checked by seeing whether the average of the four annual amounts is $70,000.

This method is not strictly applicable to fiscal year taxpayers, but might yield acceptable results if not more than two or three months of 1940 were included in the taxpayer's base period.

(b) If the taxpayer had no deficit years in the base period, reconstructed net income might in appropriate cases be allocated to individual base period years in the same proportion as its actual income was reported. The computation would require, first, the computation of the four-year average, second

the division of each year's income by this average, expressing the results as index numbers or percentages, and, finally, the multiplication of the constructive average base period net income by these indexes, as in the example (i) above.

(c) If the taxpayer had one or more deficit years in the base period, the method in (ii) above is inapplicable, and the following substitute method may be satisfactory. Subtract the average of the profits of the four base period years (including deficits) from the constructive average base period net income, and add this difference to the actual profit or loss in each base period taxable year which includes 12 months. In case of a taxable year of less than 12 months add a proportionate part.

(3) *Adjustment of abnormal deductions in the base period years.*

Section 711(b)(1)(H), (I), (J), and (K) provides generally for adjustment of deductions for judgments, intangible drilling and development costs and other items in the base period years in cases in which the deductions exceed 125 percent of the average of such deductions in the four preceding taxable years. The adjustment so provided operates automatically under that section to eliminate the excess.

Adjustments to deductions will be made in the reconstruction of base period income under section 722 only if and to the extent the deductions are abnormal within the intent and meaning of section 722. The existence in a base period year of a deduction in excess of 125 percent of the average amount of such deductions in the four preceding taxable years does not necessarily mean that the deduction is abnormal for the purposes of section 722, or that it results from conditions which are not normal for the particular taxpayer. Accordingly, the circumstances giving rise to the deduction must in each case be ascertained and examined in the light of the normal operating conditions of the particular taxpayer. To the extent that the deduction is determined to be abnormal under section 722, adjustment will be made in the reconstruction of the taxpayer's base period net income, without reference to the arbitrary mathematical adjustment provided by section 711(b)(1). This means that the adjustments made in the base period reconstruction may be more or less than the adjustment produced by the mathematical formula contained in section 711(b)(1)(H), (I), (J) and (K).

To illustrate, assume that the taxpayer had a strike during December 1936 and January 1937. It had substantial deduction in each month for extraordinary expense in connection with the strike. Under the 125 percent formula in section 711(b)(1)(J), all of the deduction for 1936 was eliminated but only a part of the 1937 deduction was eliminated. If the strike qualifies the taxpayer for relief under section 722(b)(1), the deductions for both 1936 and 1937 would be eliminated.

(E) Application of the deficit and the 75 percent rules and the growth formula in computation of constructive average base period net income.

Law.—Section 713(e)(1), section 713(f), and section 722(a).

Regulations.—Section 35.722-2(b)(1) and section 30.722-2(b)(1), as amended by T. D. 5415.

(1) *In general.*

Under the provisions of section 713, the actual average base period net income is computed under certain rules contained in section 713(e)(1) [which] provides for the elimination of the largest deficit in any base period year. This provision will be referred to as the "deficit rule." For years beginning after

December 31, 1941, section 713(e)(1) provides generally for the increase of income for the lowest year in the base period to 75 percent of the average of the other base period years. This provision will be referred to as the "75 percent rule." Section 713(f) provides for the computation of an amount greater than the straight arithmetic average of the base period earnings based on increased earnings in the second half of the base period. This provision will be referred to as the "growth formula."

The use of these rules or methods of computation is automatic in the determination of actual average base period net income and, subject to specific limitations contained in each section, the taxpayer need not prove or justify its right to use the method which is most beneficial to it. The provisions making the application of such rules automatic in the determination of actual base period net income do not, however, extend to the determination of the fair and just amount representing normal earnings under section 722. The regulations (Regulations 109, section 30.722-2(b)(1) and Regulations 112, section 35.722-2(b)(1)), as amended by T. D. 5415, provide as follows:

> "(1) Section 722(a) provides for the determination of a constructive average base period net income to be used in lieu of the actual average base period net income in those cases to which section 722 is applicable. Therefore, in computing such amount a taxpayer is not entitled to use the rules provided by section 713 (e)(1), relating to increase in base period net income of lowest year of base period, or by section 713(f), relating to average base period net income in case of increased earnings in last half of base period."

The following discussion will indicate the treatment to be accorded the rules provided by section 713(e)(1) and section 713(f) in the determination of the constructive average base period net income under section 722.

(2) *The growth formula.*

The regulations (Regulations 109, section 30.722-2(b)(1) and Regulations 112, section 35.722-2(b)(1), as amended by T. D. 5415), provide in part as follows:

> "In a proper case * * * the principles underlying section 713(f) relating to growth may be taken into account in arriving at the fair and just amount representing normal earnings if, and to the extent that, the application of such principles is reasonable and consistent with the conditions and limitations of section 722."

The provision of the Internal Revenue Code relating to growth was not contained in the Excess Profits Tax Act of 1940, but was added by the Excess Profits Tax Amendments of 1941. Congressional committee reports on the bill indicate an intention to recognize that, for a growing corporation, a straight arithmetic average base period income is not a fair measure for determining excess profits.

The House Report No. 146, C. B. 1941-1, page 553, states in part as follows:

> "Section 4. Computation of Average Base Period Net Income.
>
> "The amendments made by this section are designed for the relief of corporations that experienced rapid growth during the base period. In determining the excess profits credit based on income the present law requires the use of the average earning experience of the corporation during the years in the base period. Trends of growth during this period are given no weight. Thus, corporations which have materially expanded in the base period and have for the last year in such period a business capacity and an income much larger than that for the first year, are restricted under existing law to the use of a level average of such years. The inequities of this treatment may be illustrated by a comparison of two corporations, both of which have average base period earnings of $250,000

and, under the present law, the same credit based on income. One of these corporations has shown substantial growth during these base period years while the other has maintained a constant level.

Tax year	Excess profits net income	
	Corporation A	Corporation B
1936	$ 250,000	$ 100,000
1937	250,000	200,000
1938	250,000	300,000
1939	250,000	400,000
Total	1,000,000	1,000,000
Average	250,000	250,000

> "To give these two corporations the same excess-profits credit based on income as does the existing law, operates inequitably in the case of Corporation B, whose earnings have steadily increased during the base period. A credit of $250,000 does not properly reflect its earning power as of the time the excess-profits tax became applicable."

The principle underlying section 713(f) is therefore the recognition of the factor of growth in computing average base period net income. Consequently, a proper case under section 722 for the application of the principles of the growth formula is one in which the factor of true growth is present, but has not been adequately taken into account. In cases in which section 722 has not been invoked, the growth formula is applied automatically, whether or not the corporation exhibits true growth. Under section 722, a fair and just amount representing normal earnings is sought. If the growth formula is applied automatically in computing constructive average base period net income, regardless of true growth, the result may be a distortion of normal earnings. Therefore, any case in which true growth is not demonstrated is not a proper case for the application of the principle of the growth formula.

While it is necessary to investigate the presence of true growth only when the earnings in the second half of the base period exceed those of the first half, the mere increase in earnings is not a conclusive indication of true growth. The determination of whether true growth is present involves consideration not only of the corporation's earning experience, but also of the physical volume and dollar amount of its sales.

The mere increase in earnings, where the physical volume of sales remains static or is decreasing, does not represent true growth and the principle of section 713(f) is inapplicable. Such increase may have been solely the result of lower unit costs or higher sales prices, or of some other factor unrelated to expanded operations.

Ordinarily, the mathematical formula contained in section 713(f) will correctly compensate for the factor of true growth. However, in some cases it is possible that the rigid formula may result in an amount in excess of normal earnings corrected for growth. This may come about by reason of one or more "good" years in the base period which cannot be adjusted for any specific abnormality, but which, through the application of the mathematical formula, produce a result in excess of any reasonable correction for the factor of true growth. When this situation occurs, the exact mathematical formula should not be used. Instead a trend of reasonable growth should be substituted.

Under section 722(b)(1) and (2) reconstruction of average base period net income does not provide for the factor of growth. Therefore, if the reconstructed income for the second half of the base period exceeds that for the

first half, and this increase is found attributable to true growth, application of the principle of the growth formula will be allowed.

Under section 722(b)(3) the factor of growth ordinarily will have been taken into account in the reconstruction. Therefore, whether the reconstruction is made for four separate base period years, or for the base period as a whole, the use of the growth formula in the computation will not be allowed.

Under section 722(b)(4), the two-year push-back rule will account for the initial developmental period of the new or changed business but not for the normal growth thereafter. Accordingly, under section 722(b)(4) determination will have to be made as to whether the base period earnings of the taxpayer as reconstructed after application of the push-back exhibit true growth, and to apply section 713(f) when such growth is exhibited.

(3) *The 75 percent rule and deficit rule.*

The regulations (Regulations 109, section 30.722-2(b)(1) and Regulations 112, section 35.722-2(b)(1), as amended by T. D. 5415), provide in part as follows:

> "Since the constructive average base period net income is the fair and just amount representing normal earnings and will reflect adjustments for abnormally low base period years, a taxpayer having computed such amount is not entitled in addition to apply the rules provided by section 713(e)(1)."

The 75 percent rule and the deficit rule will, accordingly, not be applied in the computation of the constructive average base period net income under section 722.

(F) Cases involving the application of both section 722 and section 721.

Law.—Section 721(f).

Regulations.—Section 35.721-7.

Sections 722 and 721 are both concerned with the treatment of abnormalities in income. Section 722 relates to abnormalities in the base period income, while section 721 deals with abnormal income during the excess profits tax taxable years.

Section 721 operates to transfer or "attribute" to other years certain income of the excess profits tax taxable year which is deemed to be abnormal for excess profits tax purposes. Section 721(a) provides for the determination of the kind and amount of net income which is abnormal. Section 721(b) provides for the determination of the amount of net abnormal income which is attributable to other years, either prior or future. Section 721(c) provides for a computation of tax for the current taxable year, which, in effect, limits the excess profits tax to an amount which would have been paid had the net abnormal income been reported in the years to which it is attributable.

The application of section 721 results in the complete exclusion from income subject to excess profits tax of any abnormal income which is attributed to years beginning prior to January 1, 1940, since there was no excess profits tax for such years. Income which is attributable to years prior to January 1, 1940 has no effect upon base period net income for excess profits tax purposes.

Section 721 and section 722 are not mutually exclusive. The application of one section does not prohibit the application of the other section to the same taxpayer. For example, a taxpayer may be entitled to the benefits of section 721 because it has "income arising out of a claim, award, judgment, or decree." It is also established that it is entitled to relief under section 722 because of a fire in the year 1937 which destroyed a part of its plant. This taxpayer would be entitled to the benefits obtained by the application of both

sections. However, if both sections are applicable and the ground for relief under section 721 is section 721(a)(2)(C) and the basis for relief under section 722 is operations of the same nature, a special adjustment must be made.

Section 721(a)(2)(C) provides for relief if income is received during the taxable year from exploration, discovery, prospecting, research or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months. Such operations may also be grounds for relief under section 722(b)(4) if the corporation changed the character of its business to include such operations during the base period.

If such income is taken into account under section 722 in computing constructive average base period net income, section 721(f) provides that "only such portion of the income in the taxable year * * * as is attributable to another taxable year under this subchapter shall be deemed attributable to a year other than the taxable year." In other words, any income attributable to years beginning prior to January 1, 1940 is deemed to be attributable to the current taxable year. Thus, a portion of the income which was excluded from the current taxable year under section 721 is restored to the current taxable year.

For example, assume that a corporation was organized and commenced the development of an oil lease in January 1938. It drilled oil wells on the lease in each of the years 1938, 1939, 1940 and 1941. In its return for 1942 it claimed the benefits of section 721. Net abnormal income of $60,000 was determined to be attributable to prior years as follows:

1938	$15,000
1939	25,000
1940	10,000
1941	10,000
Total	$60,000

If the corporation files a claim for relief under section 722 for 1942 and is allowed a constructive average base period net income which takes into account the development of the lease during 1938 and 1939, the net abnormal income will be deemed to be attributable only to excess profits tax taxable years as follows:

1940	$10,000
1941	10,000
1942	40,000
Total	$60,000

The tax computation will be made under section 721(c) on the basis of the above allocation, after allowance of an excess profits credit computed under section 722. It should be noted that a new allocation to the prior excess profits tax taxable years is not made. For example, in the above illustration a reallocation of $40,000 (attributable to 1938 and 1939) to the years 1940 and 1941 is not made. Section 721(f) provides that only the income attributable to an excess profits tax year will be deemed to be attributable to a year other than the taxable year. Any income attributable to a non-excess profits tax year will therefore be deemed attributable to the current taxable year.

It is believed that there will be few instances in which the grounds for relief under section 721 will be the same as the grounds for relief under section 722, other than cases under section 721(a)(2)(C). In any such instance care should be taken to avoid an allowance under both sections which would result in a double benefit.

(G) Supplement A corporations.

The regulations promulgated under section 722(e)(2) (section 30.722-2 (b)(4) of Regulations 109 and section 35.722-2(b)(4) of Regulations 112) provide that if the taxpayer has acquired the business of any other person (corporation, partnership, or individual) called "a component corporation" in a transaction which enables the taxpayer to compute its average base period net income under the provisions of Supplement A, the business of such component corporation shall be considered to be a part of the business of the taxpayer for the period for which the income of such component corporation is included in the computation of the average base period net income of the taxpayer under Supplement A.

Accordingly, any event or condition within such period affecting the net income of the component corporation which would make applicable the provisions of section 722 will be considered to be an event or condition affecting the base period net income of the taxpayer. For example, a manufacturing corporation was merged into a distributing corporation in January 1940, and the continuing corporation carried on both businesses thereafter. A new product developed by the manufacturing corporation during the period its income is included in the average base period net income will be considered to be a new product developed by the continuing corporation.

To the extent that the base period income of a component corporation is not included in the Supplement A computation of the acquiring corporation because of the provisions of section 742(f)(1), the business of the component corporation will not be considered to be a part of the business of the acquiring corporation.

If a constructive average base period net income has been finally determined and used by a component corporation for a period prior to its acquisition by an acquiring corporation, the acquiring corporation cannot as a matter of right use such constructive average base period net income in determining its average base period net income under Supplement A. (See I. T. 3617, C. B. 1943, 885.) The acquiring corporation must establish for itself that the provisions of section 722 are applicable and if so, what would constitute a fair and just amount representing normal earnings to be used as a constructive average base period net income.

If, during the base period, a taxpayer acquired in a non-Supplement A transaction substantially all the assets of another corporation which then ceased business, if as a result of such acquisition the taxpayer is entitled to relief, and if comparability of pertinent operating conditions is established, income experience attributable to those assets in the hands of the predecessor may be used by the taxpayer in its reconstruction. Several points, however, must be noted with respect to this type of case. First, the mere acquisition of assets does not necessarily entitle the taxpayer to relief. The acquired assets may duplicate existing facilities of the taxpayer, or they may represent an increase in the taxpayer's capacity for production. Second, any items of income and deductions of the predecessor used by the taxpayer must be analyzed to determine that they represent normal operating conditions. Third, care must be taken that the taxpayer's method of operating the assets acquired is the same as that used by the predecessor, and that the use of the predecessor's items of income and deductions properly reflects the taxpayer's normal operating conditions. In short, the use of a predecessor's experience represents the use of a comparative concern and must be attended by all the qualifications and limitations which relate to comparatives.

Part IX

PROCEDURE AND ADMINISTRATION

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(A) Preliminary survey of claims.

Before a claim (Form 991) is examined on its merits it will receive a preliminary investigation to ascertain whether it is otherwise valid.

A claim may be disposed of without further investigation on one of three grounds: (1) that it was not filed within the statutory period; (2) that consideration is barred by a previous agreement; or (3) that there is no excess profits tax for the year in question.

Although, in general, a claim under section 722 must be filed within three years from the time the return was filed, or within two years from the time the tax was paid, this period may have been extended (subject to the limitations of section 322(b)(3)) by a waiver under section 276(b) extending the time for assessment of tax. A claim (Form 991) asking for the determination of a constructive average base period net income for a given year in order to secure the benefit of a carry-over of an alleged unused excess profits credit to the two succeeding years must be filed within the statutory period applicable to the year in which the carry-over is to be used. Consequently, a claim is not untimely filed merely because the statutory period has run with respect to the year in which the carry-over arose.

An application for relief may have been filed for a year in which there is no excess profits tax liability, possibly as a precaution in case a tax liability were disclosed by an internal revenue agent's examination, or as the basis for securing a carry-over or carry-back of a larger unused excess profits credit. In such cases, no consideration can be given to the application. If a redetermination of the excess profits credit for such year would reduce the tax liability for another year an application for relief should be filed with respect to the year for which such reduction in tax is claimed.

(B) Defective or inadequate claims.

A claim not filed under oath, or one which does not set forth information required by the instructions contained in section 30.722-5(b), Regulations 109, or section 35.722-5(b), Regulations 112, might properly be disallowed without further investigation. However, considerations of good administration require that the taxpayer should be given reasonable opportunity to perfect the claim. In such cases the taxpayer should be advised of the defects or inadequacy and given a reasonable time to amend the claim or submit the information required. The time allowed for the correction of such applications is within the discretion of the field office.

If, however, there is reason to believe that the taxpayer is not acting in good faith, or that, even with further time, the taxpayer will not be able to present sufficient evidence to indicate the probable merits of its claim, the claim may be summarily disallowed.

If it is decided that the taxpayer should be given time to complete its claim or to present additional data in support of the grounds already stated, this may be done even if the statutory period for filing an original claim has expired. However, care will be exercised to distinguish between such cases and those where new grounds are proposed after the limitations period has expired.

(C) Withdrawal of applications for relief.

Under certain circumstances a taxpayer may desire to withdraw an application for relief without prejudice to its right to file another application within the time prescribed by section 722(d). Such requests for withdrawal should be in writing and executed under oath by at least two officers empowered to sign for the corporation, and the corporate seal should be affixed. If the corporation has no seal, the request for withdrawals should be accompanied by a certified copy of the resolution of the Board of Directors giving such officers authority to sign the request. In such case, no notice of disallowance under section 732 will be issued. In any case in which the application is withdrawn as indicated, the case will be treated as though no application for relief had been filed.

This procedure for the withdrawal of applications for relief is applicable only to those cases in which there has been no substantial investigative action. Included in this category are so-called "protective" or incomplete applications which were filed for the purpose of complying with the original statutory filing period which expired September 15, 1943. Such applications were filed without sufficient data and, because of inability to compile the necessary information prior to an examination, or for reasons that may have developed subsequent to filing, the taxpayers do not desire to pursue their applications.

(D) Publicity and interest data.

Law.—Sections 722(g), 292(b), 3771(g).

Section 208 of the Revenue Act of 1943 (enacted February, 1944) added subsection (g) to section 722. This subsection provides that the Commissioner shall compile lists, to be published in the Federal Register, of all cases in which relief under section 722 has been allowed during each fiscal year beginning after June 30, 1941. These lists must show the name and address of each taxpayer, the business in which it is engaged, and five items, as follows:

(1) The excess profits credit without the application of section 722;
(2) The increase in the excess profits credit claimed;
(3) The increase in the excess profits credit allowed under section 722;
(4) The gross reduction in excess profits tax resulting from the application of section 722; and,
(5) The gross increase in income taxes resulting from the application of section 722.

A distinction is made between amounts allowed by The Tax Court of the United States and amounts allowed by the Commissioner. If a petition is filed with the Tax Court, items (3), (4) and (5) will reflect the determination made by the Court, as well as the Commissioner's determination.

The gross reduction in excess profits tax is the difference between the excess profits tax computed without the application of section 722 and before

any credits for debt retirement or foreign taxes or any adjustment under section 734, and the excess profits tax after the application of section 722 but before such credits or adjustment. Similarly, the gross increase in income taxes referred to is the increase in income taxes computed before the credit for foreign taxes. For taxable years beginning in 1940 there will be no increase of income taxes attributable to the effect of section 722 on excess profits taxes; for taxable years beginning in 1941 net income will be increased by the amount of the reduction in excess profits tax (without any foreign tax credit or section 734 adjustment) caused by section 722; while for taxable years beginning after December 31, 1941, normal tax net income and surtax net income are generally increased by the amount of the decrease in adjusted excess profits net income produced by section 722.

Public Law 201, approved December 17, 1943, in addition to amending section 722(d) added to the Code subsections 3771(g) and 292(b) relating to interest. Subsection 3771(g) provides, for taxable years beginning in 1940 or 1941, that no interest shall be paid on "any part of an overpayment * * * determined by the Commissioner to be attributable to the final determination of an application for relief or benefit under section 722." For taxable years beginning after December 31, 1941, this subsection provides that interest on any part of an overpayment attributable to section 722 shall not be paid for any period prior to September 16, 1945, or one year after the filing of the application for relief for such year, whichever is the later.

In general, this subsection applies only to overpayments of excess profits tax, since ordinarily a final determination of an application for relief under section 722 results in a reduction of excess profits tax or adjusted excess profits net income which in turn produces a deficiency, rather than an overpayment, of income taxes. However, where the taxpayer uses in its excess profits tax return the constructive average base period net income determined under section 722 for a prior year, there may be an overassessment of income taxes attributable to "the final determination of an application for relief or benefit under section 722." In such a case the final determination might be the allowance of a smaller excess profits credit than that used in the excess profits tax return, with corresponding increase in the adjusted excess profits net income used as a credit under section 26(e) in computing income taxes. This situation may arise in the application of the variable credit rule to a taxpayer which abandons an established change in character in a subsequent year but fails to reduce its constructive average base period net income accordingly.

Subsection (b) of section 292 deals with interest on deficiencies. For taxable years beginning prior to January 1, 1942 no interest shall be charged on "any part of a deficiency * * * determined by the Commissioner to be attributable to the final determination of an application for relief or benefit under section 722." In general, this provision applies only to deficiencies of income taxes for taxable years beginning in 1941. It would also apply, however, to a deficiency of excess profits tax for either 1940 or 1941 resulting from a redetermination reducing the constructive average base period net income after a refund had previously been allowed.

For taxable years beginning after December 31, 1941, this subsection provides, in general, that, for "any part of a deficiency" attributable to the application of section 722, interest shall be charged only for periods after September 16, 1945, or one year from the filing of the application for relief under section 722, whichever is the later. This provision applies principally to deficiencies of income tax resulting from a decreased credit under section 26(e)

due to the application of section 722, although it may also apply to deficiencies of excess profits tax resulting from a redetermination of the constructive average base period net income after a refund has been made, or a return filed on the basis of a previous determination of a larger constructive average base period net income.

For example, a taxpayer files an application for relief for the calendar year 1941. It is determined that an increase in the excess profits credit in the amount of $100,000 is allowable. There are no other adjustments affecting the income or excess profits tax liability. A refund of $60,000 excess profits tax and a deficiency of $18,600 normal tax and surtax resulting from the adjustment under section 722 would bear no interest regardless of the date the determination was made.

The computation is more difficult if there are adjustments in addition to those attributable to the application of section 722. Sections 3771(g) and 292(b) place restrictions on the interest which is computed on "any part" of a refund or deficiency "attributable to the final determination of an application for relief or benefit under section 722." These restrictions require that no interest will be allowed or charged on any such part of a refund or deficiency for years beginning in 1940 and 1941, and that for 1942 and subsequent years no interest will be allowed or charged prior to September 16, 1945, or one year after filing the application for relief, whichever is the later. Therefore, it is necessary to determine the parts of the refund and deficiency which result from the section 722 adjustment. If the adjustment under section 722 is partially offset by other adjustments which tend to increase the excess profits tax liability, the interest will not be computed on the net refund. In the light of the foregoing statutory provisions restricting interest on that part of a deficiency or refund which is attributable to relief under section 722 and the absence of similar provisions for the computation of interest on deficiencies and refund attributable to non-section 722 issues, it is the apparent intent of Congress to subject the entire amount of the refund attributable to section 722 to the restrictions, regardless of whether or not the determinations with respect to ordinary adjustments and to section 722 are made at the same time. This conclusion is indicated by the case of Uni-Term Stevedoring Co., Inc., (1944) 3 T. C. 917 which establishes that the issue of relief under section 722 may be determined independently of other issues affecting tax liability. Accordingly, interest would be due on the total amount of a deficiency attributable to such other issues from the due date for filing the return, and interest would be allowed on the total amount of the overassessments attributable to an adjustment under section 722 but only for the time provided by section 3771(g).

To illustrate, assume that for the calendar year 1941 the excess profits credit was increased $100,000 as a result of the application of section 722. If other adjustments are made which increase net income $50,000, the computation of the overassessment attributable to section 722 would be as follows:

Excess Profits Tax	Return	Without Section 722	After Section 722
Net income	$200,000	$250,000	$250,000
Less: Specific exemption and excess profits credit	80,000	80,000	180,000
Adjusted excess profits net income	$120,000	$170,000	$ 70,000
Excess profits tax liability	$ 51,500	$ 76,500	$ 28,000
Previously assessed		51,500	51,500
Deficiency (or overassessment)		$ 25,000	$(23,500)

Normal Tax and Surtax	Return	Without Section 722	After Section 722
Net income before excess profits tax	$210,000	$260,000	$260,000
Less: Excess profits tax	51,500	76,500	28,000
Normal tax and surtax net income	$158,500	$183,500	$232,000
Normal tax and surtax liability	$ 48,885	$ 56,635	$ 71,670
Previously assessed		48,885	48,885
Deficiency		$ 7,750	$ 22,785

Summary	Without Section 722	After Section 722	Attributable to Section 722
Excess profits tax deficiency (or overassessment)	$ 25,000	$(23,500)	$(48,500)
Normal tax and surtax deficiency	7,750	22,785	15,035
Net deficiency (or overassessment)	$ 32,750	$ (715)	$(33,465)

Interest will be charged on the deficiency of $32,750. No interest will be allowed on the overassessment of $33,465 for the reason that subsection 3771 (g) provides that no interest will be paid on overassessments attributable to section 722 for taxable years beginning in 1940 and 1941.

There are two important exceptions to the general provisions contained in section 292(b). The first is that interest shall be charged on a deficiency of excess profits tax resulting from a deferment under section 710(a)(5). Thus, a taxpayer with an excess profits tax liability of $90,000 without the application of section 722 might claim that there would be no excess profits tax with the benefits of section 722. On the return 33 percent of $90,000, or $29,700, would be deferred, and $60,300 would be payable. If the final determination of the claim under section 722 resulted in an excess profits tax of $75,000, the claim being allowed only in part, a deficiency of $14,700 would result. Since the taxpayer will have had the use of this amount during the interval, interest is properly chargeable on the deficiency.

The other exception relates to a deficiency of income taxes where a deferment under section 710(a)(5) has been made. In such cases interest is charged on that portion of a deficiency of income taxes arising from the application of section 722 which exceeds a refund of excess profits tax resulting from the application of section 722. This may be illustrated as follows:

The taxpayer's net income and excess profits net income for the calendar year 1942 is $305,000, and the actual excess profits credit is $100,000. Attached to the return is an application for relief under section 722 alleging that a constructive average base period net income should be allowed which would result in a credit of $200,000. A deferment of excess profits tax in the amount of $29,700 is claimed under the provisions of section 710(a)(5), which is correctly computed as 33 percent of the reduction in excess profits tax resulting from the application of section 722.

An investigation shows that the taxpayer is entitled to an excess profits credit of $150,000 under the provisions of section 722. Assuming there are no other adjustments, the following computations will result:

	Per Return	After Allowance of Section 722
Excess profits net income	$305,000	$305,000
Less: Specific exemption and excess profits credit	105,000	155,000
Adjusted excess profits net income	$200,000	$150,000
Excess profits tax at 90%	$180,000	$135,000
Less: Amount deferred (33% of $90,000)	29,700	
Tax as shown on the return	$150,300	150,300
Overassessment of excess profits tax		$ 15,300
Net income	$305,000	$305,000
Less: Adjusted excess profits net income	200,000	150,000
Normal tax and surtax net income	$105,000	$155,000
Normal tax and surtax at 40%	$ 42,000	$ 62,000
Deficiency of income taxes		$ 20,000

In accordance with the provisions of section 292(b), interest will run from March 15, 1943, on the excess of the deficiency in income tax over the overassessment of excess profits tax ($20,000 minus $15,300) or $4,700.

The reason for the full interest charge on $4,700 is not readily apparent and requires some explanation. The deferment is 33 percent of the excess profits tax refund claimed. There is no adjustment of income taxes because of the deferment. However, if the claim is allowed, the refund of excess profits tax of 90 percent will be offset by a deficiency of income tax of 40 percent. The net refund will therefore generally be 50 percent of the increase in the excess profits credit. Thus, in the above example an increase in the excess profits credit of $50,000 would ordinarily result in an overassessment of excess profits tax of $45,000 and a deficiency of income tax of $20,000, or a net overassessment of $25,000. But the taxpayer has already deferred $29,700 and it should therefore pay interest in full on the excessive deferment of $4,700.

If the taxpayer is allowed an excess profits credit which produces a net refund equal to the amount deferred, there will be no net refund or deficiency. Thus, in the above illustration an increase in the excess profits credit of $59,400 would produce the following result:

Excess profits net income	$305,000
Less: Specific exemption and excess profits credit	164,400
Adjusted excess profits net income	$140,600
Excess profits tax at 90%	$126,540
Excess profits tax assessed	150,300
Overpayment of excess profits tax	$ 23,760

Net income	$305,000
Less: Adjusted excess profits net income	140,600
Normal tax and surtax net income	$164,400
Normal tax and surtax at 40%	$ 65,760
Previously assessed	42,000
Deficiency of income taxes	$ 23,760

In some instances the increase allowed in the excess profits credit may be small in proportion to the increase claimed. If a deferment under section 710(a)(5) is claimed in such cases, there will result a deficiency in both income and excess profits taxes. Thus, in the above example assume that an increase in the credit of only $30,000 is allowed. The tax computation would be as follows:

Excess profits net income	$305,000
Less: Specific exemption and excess profits credit	135,000
Adjusted excess profits net income	$170,000
Excess profits tax at 90%	$153,000
Excess profits tax assessed	150,300
Deficiency of excess profits tax	$ 2,700
Net income	$305,000
Less: Adjusted excess profits net income	170,000
Normal tax and surtax net income	$135,000
Normal tax and surtax at 40%	$ 54,000
Previously assessed	42,000
Deficiency of income taxes	$ 12,000
Total deficiency	$ 14,700

Both deficiencies will bear interest from March 15, 1943. Since an increase in the excess profits credit of $30,000 would result in a net overassessment of $15,000 and the taxpayer has deferred $29,700, it should pay interest in full on the excessive deferment of $14,700.

If the increase allowed in the excess profits credit is large, the taxpayer may be entitled to more than it has deferred. Thus, in the above example assume that an increase of $60,000 is allowed. The tax computation would be as follows:

Excess profits net income	$305,000
Less: Specific exemption and excess profits credit	165,000
Adjusted excess profits net income	$140,000
Excess profits tax at 90%	$126,000
Excess profits tax assessed	150,300
Overassessment of excess profits tax	$ 24,300

Net income	$305,000
Less: Adjusted excess profits net income	140,000
Normal tax and surtax net income	$165,000
Normal tax and surtax at 40%	$ 66,000
Previously assessed	42,000
Deficiency of income taxes	$ 24,000
Net overassessment	$ 300

Since the deficiency in income taxes does not exceed the overassessment of excess profits taxes, interest will not start to run on either deficiency or overassessment until September 16, 1945, or one year after the filing of the application for relief, whichever is the later.

In determining the portion of a deficiency or overassessment which is attributable to the application for relief under section 722, consideration must be given to any increase in an unused excess profits credit carry-over or carry-back resulting from the application of section 722 to a prior or subsequent year. In making the tax computation prior to the application of section 722, the unused excess profits credit carry-over or carry-back is determined without the benefit of section 722. The final computation after the application of section 722 will take into account the corrected unused credit after the application of section 722.

The foregoing may be illustrated by the following example:

Assume that for the years 1941 and 1942 the taxpayer has an actual excess profits credit of $100,000. For 1942 its net income was $410,000 and its excess profits net income after adjustments under section 711(a) was $405,000. It paid no excess profits tax for 1941 and had an unused excess profits credit carry-over to 1942 of $40,000 based on its actual excess profits credit. For 1942 it filed with its return an application for relief under section 722 claiming an increase in its excess profits credit and unused excess profits credit carry-over based on an increase in its excess profits credit of $70,000 for each of the years 1941 and 1942. It deferred $41,580 excess profits tax under the provisions of section 710(a)(5). It was determined that an increase in the excess profits credit of $30,000 should be allowed for each year. Other adjustments increased net income $50,000 in 1941 and $60,000 in 1942. Assume the following additional facts and computations of tax for 1942:

Excess Profits Tax	Return	Without Section 722	After Section 722
Net income	$405,000	$465,000	$465,000
Less: Specific exemption and excess profits credit	$105,000	$105,000	$135,000
Unused credit carry-over	40,000	None	20,000
	$145,000	$105,000	$155,000
Adjusted excess profits net income	$260,000	$360,000	$310,000
Excess profits tax liability	$234,000	$324,000	$279,000
Less: Deferment claimed—section 710(a)(5)	41,580	.....	
Excess profits tax assessed	$192,420	192,420	192,420
Deficiency		$131,580	$ 86,580
Less: Deferment under section 710(a)(5)		41,580	
Deficiency attributable to income adjustments		$ 90,000	

Normal Tax and Surtax	Return	Without Section 722	After Section 722
Net income	$410,000	$470,000	$470,000
Less: Adjusted excess profits net income	260,000	360,000	310,000
Normal tax and surtax net income	$150,000	$110,000	$160,000
Normal tax and surtax at 40%	$ 60,000	$ 44,000	$ 64,000
Previously assessed		60,000	60,000
Deficiency (or overassessment)		$(16,000)	$ 4,000

Summary	Without Section 722	After Section 722	Attributable to Section 722
Excess profits tax deficiency (or overassessment)	$ 90,000	$ 86,580	$ (3,420)
Normal tax and surtax deficiency (or overassessment)	(16,000)	4,000	20,000
Net deficiency (or overassessment)	$ 74,000	$ 90,580	$ 16,580

Interest will be charged on the deficiency of $74,000 from March 15, 1943. Since the deficiency of income tax ($20,000) exceeds the overassessment of excess profits tax attributable to section 722 ($3,420) interest on the excess of $16,580 will be charged from March 15, 1943.

(E) Disposition of examined claims.

Law.—Sections 732, 272 and 322.

Regulations.—Section 35.732-1.

Tax Court Decision.—Uni-Term Stevedoring Co., Inc., (1944) 3 T. C. 917 [CCH Dec. 13,947].

(1) *Relationship of claims under section 722 to other issues.*

A taxpayer's right to relief may be determined separately from other issues affecting its tax liability. *Uni-Term Stevedoring Co., Inc.,* (1944) 3 T. C. 917 [CCH Dec. 13,947]. Generally, it is the policy of the Bureau to consider a taxpayer's claim for relief at the same time other issues affecting its tax liability are considered. However, a separate determination may be made where extended consideration of the claim for relief is indicated. The matter is one for administrative discretion and consideration should be given to the avoidance of accumulation of interest in favor of or against the taxpayer, to the prompt collection of the revenue, and to the taxpayer's convenience where not prejudicial to the Government. Upon a determination of the taxpayer's right to relief, a statutory notice will be issued in accordance with the following procedure.

(2) *Issuance of statutory notices by internal revenue agents in charge.*

Section 732(a) states that if a claim for refund is disallowed in whole or in part, "the Commissioner shall send notice of such disallowance to the taxpayer by registered mail." Accordingly, formal statutory notices of disallowance will be issued in all cases in which such a claim is disallowed in whole or in part, even though the taxpayer has agreed to the total or partial disallowance.

The statutory notice of partial or total disallowance will be issued by the internal revenue agent in charge in any unagreed case in which no request has been made for a hearing before the Technical Staff. The statutory notice of partial or total disallowance will be issued by the internal revenue agent

in charge upon instruction by the Technical Staff in any case which has been considered by the Staff while in the pre-90-day status, in accordance with the ordinary procedure relating to statutory notices of deficiency.

Before the relief applied for on Form 991 is allowed in whole or in part, careful investigation of the status of the application as a claim for refund will be made. Section 35.722-5(c), Regulations 112, states that such an application may be considered a claim for refund of only that part of the excess profits tax for the year in question which exceeds the reduced tax as shown in the claim, and which was paid prior to the time the application (Form 991) was filed. If the taxpayer paid its excess profits tax for that year in installments the application may have been filed prior to the payment of the third or fourth installment. This is particularly true with respect to applications for the calendar year 1942, which, prior to the amendment of section 722(d) should have been filed within six months after the date prescribed for filing the return, and with respect to Forms 991 filed with the return to obtain deferment under section 710(a)(5). In such cases, or in cases where an additional amount of tax was paid with an amended return or as a deficiency, the taxpayer is required to file an ordinary claim on Form 843 for the refund of an amount in excess of that paid prior to the filing of Form 991. Where such a claim is necessary and has not been filed, but the period under section 322 in which such a claim may be filed has not expired, the taxpayer should file such a claim.

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